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Property "Flipping": HUD's Failure to Curb Mortgage Fraud

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PROPERTY "FLIPPING": HUD'S FAILURE TO CURB MORTGAGE FRAUD

REPORT

PREPARED BY THE

MINORITY STAFF

OF THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

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PROPERTY "FLIPPING": HUD'S FAILURE TO CURB MORTGAGE FRAUD

EXECUTIVE SUMMARY

In September 1999, under the chairmanship of Senator Susan M. Collins, the Permanent Subcommittee on Investigations commenced an investigation into the practice of property "flipping." The term refers to the purchase and quick resale of a home at a huge mark-up, often with little work done to improve the property, in order to create the false illusion of a robust real estate market though the use of phony paperwork and deceptive sales practices. The practice of "flipping" poses significant risks to low-income, first-time home buyers, and may affect the overall stability of a neighborhood.

A series of newspaper articles in the *Baltimore Sun* reported that flippers had purchased rundown houses over a 3-year period and resold them—sometimes within hours—to unsuspecting buyers. After reviewing this issue, Subcommittee staff came to suspect that flipping was occurring not only in Baltimore but also around the United States. During the Subcommittee's 9-month investigation into this subject, staff investigators interviewed over 100 witnesses, including home buyer victims, real estate brokers, lenders, and attorneys involved in mortgage flipping cases, as well as government officials, community activists, and other stakeholders. These investigative efforts confirmed that the phenomenon of flipping is not simply a local, State, or even regional problem. It is, rather, a significant nationwide problem.

Although the purchase and quick resale of a house at an increased price are not in and of themselves unlawful, the practice can cross into illegality when documents are falsified in order to lure lenders or buyers into investing more money in a house than it is actually worth. In order to finance the transaction, such unscrupulous sellers may also make arrangements to secure a mortgage that is insured by the Federal Housing Authority (FHA). The principal advantage to having an FHA-backed mortgage is that if the buyer defaults, the government will reimburse the lender for almost the entire amount of the loan. As a result, where the FHA backs mortgages, there is minimal risk in lending money to marginally qualified borrowers. Designed as a means to facilitate loans to low-income families with little credit history, this system is sometimes subject to abuse where unscrupulous sellers are concerned: Too often, the process results in the Federal Government either insuring questionable loans or simply subsidizing mortgage fraud.

The Subcommittee's investigation culminated in 2 days of Congressional oversight hearings on June 29 and 30, 2000. Among the witnesses who testified were three purchasers of flipped homes: Lisa Smith, a New York City police officer, and single mother; Sonia Pratts, a health care assistant from Hollywood, Florida; and Steekena Rollins, a day-care service provider from Chicago, Illinois. All three spent their entire life savings to buy into the American dream of home ownership, only to have their experience transformed into a nightmare. As Chairman Collins said in her opening statement:

> "I find it very troubling that so many citizens in our Nation's cities have been victimized by the predatory practices of unscrupulous real estate agencies, appraisers, and lenders. But what I find most appalling is that the Federal Government has essentially subsidized much of this fraud."[1]

The Subcommittee also heard testimony from the Hon. Barbara A. Mikulski, a U.S. Senator from the State of Maryland; Stanley J. Czerwinski, Associate Director, Housing and Community Development Issues, Resources, Community, and Economic Development Division, U.S. General Accounting Office (GAO); William C. Apgar, Assistant Secretary for Housing and Federal Housing Commissioner, U.S. Department of Housing and Urban Development (HUD); and Susan Gaffney, Inspector General, U.S. Department of Housing and Urban Development (HUD).

Senator Mikulski testified that the flipping problem in Baltimore was indeed "horrifying." She noted that every time a homeowner defaulted on a house, the FHA would have to foreclose on the property and the homeowner could lose as much as $40,000—ultimately leaving the Federal taxpayer with liability. Senator Mikulski also testified that after learning of the flipping problem in Baltimore, she met with then-HUD Secretary Andrew Cuomo to discuss possible solutions. Subsequently, two separate task forces were established to investigate the flipping epidemic, and to prevent additional foreclosures from occurring.

In April 2000, HUD joined forces with the Department of the Treasury to form the Joint Task Force on Predatory Lending and the Baltimore Predatory Lending Task Force. The Joint Task Force (JTF) consists of representatives from consumer, civil rights, community, and industry groups, as well as State and local governments. The Baltimore Task Force (BTF) was launched to gather information on the cause and extent of mortgage frauds and resulting foreclosures, and to develop information that benefits Baltimore and serves as a programmatic reform throughout the Nation. FHA imposed a 90-day moratorium on foreclosures of FHA-insured loans in Baltimore City, which enabled HUD to send what it described as a "Swat Team" of officials to Baltimore to identify fraud or predatory practices involved in FHA-backed loans before foreclosure and to help as many homeowners as possible avoid foreclosures.

[1] *HUD's Government-Insured Mortgages: The Problem of Property "Flipping",* hearings before the Permanent Subcommittee on Investigations, Committee on Governmental Affairs, 107th Congress, 1st Session (June 29–30, 2000) [hereinafter "Hearing record"], at 3.

At the request of Senator Collins and Representative Rick Lazio (R–NY), GAO prepared a report entitled, "Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk." Stanley Czerwinski—accompanied by Robert Procaccini, Assistant Director for FHA Insurance Programs, and Paul Schmidt, Assistant Director for Single-Family Housing Programs—appeared before the Subcommittee to discuss GAO's findings.

As the GAO officials made clear, FHA is the principal provider of Federal mortgage insurance, and is also the major lending source for first-time, low-income, and minority home buyers. As such, the agency relies on approximately 10,000 lenders to carry out its mission, and about 2,900 of those lenders are granted "Direct-Endorsement" (DE) authority. This means that these lenders can gather and process loan information, underwrite the loans, and make eligibility determinations, all without prior HUD review.

Given HUD's reliance on private lenders and the authority they are given to act on HUD's behalf, oversight is essential. GAO's review found problems with HUD's oversight of the program. Specifically, GAO identified problems in three particular areas: (1) HUD's process for granting FHA-approved lenders DE authority provides only limited assurance that the lenders are in fact qualified; (2) HUD's monitoring of lenders does not adequately focus on the lenders and loans that pose the greatest insurance risks to the Department; and (3) HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations.

Senator Collins noted that the problems GAO identified in this report were long-standing issues of which HUD had already been advised in prior audits and reports. Despite this history of studies calling attention to the problem, however, no apparent progress had been made to remedy the deficiencies. In 1993, for example, HUD's Office of the Inspector General (OIG) completed an audit of FHA's single-family mortgage program and found that HUD's post-endorsement reviews did not consistently ensure quality underwriting. In 1997, the GAO evaluated the appraisal process and found that HUD was not adequately monitoring appraisers—as well as that the agency was not moving effectively against faulty appraisers. Finally, in 1999, the GAO issued yet another report on the subject. Entitled "Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process," this study similarly found that: (a) HUD was still not doing a good job monitoring the performance of appraisers; (b) HUD was not holding appraisers accountable for the quality of their appraisals, and (c) the Department had limited assurance that its appraisers were in fact knowledgeable.

On June 30, 2000, the Subcommittee heard from FHA Commissioner Apgar who testified about the steps HUD has taken to combat flipping, and what assistance the agency would provide to help victims of mortgage fraud recover. Specifically, he identified Credit Watch, a performance-based lender monitoring and enforcement system that was launched in May 1999, and the Homebuyer Protection Plan, a more comprehensive and thorough appraisal process that FHA implemented in 1998. He also testified that:

> "HUD will move aggressively to force lenders to restructure inflated mortgages that result from fraudulent ap-

> praisals or the so-called property flips. We will push the loan back to the lender and make him responsible for producing a loan that the borrower can afford. If not, the FHA will intervene directly and make the loan right for the borrower." [2]

Despite these assurances, however, more than a year later this promised relief has yet to appear. Apgar, a Clinton Administration appointee, left HUD early in 2001 after the change in administrations. Apgar's promises to the Subcommittee, and to borrowers across the country, now appear to have been empty ones. According to HUD official Laurie Maggiano, in fact, the law prevents HUD from forcing lenders to reduce loans that FHA insures. On May 14, 2001, during a Senate field hearing in Baltimore, Maryland, Maggiano advised Senator Mikulski that in Apgar's Subcommittee testimony, "FHA perhaps over committed what it was able to deliver."

In those cases where HUD did ask lenders to reduce loans, these institutions simply refused, being under no legal obligation to comply. After receiving numerous complaints from community activists and nonprofit housing agencies that HUD had failed to deliver on the promises made during the tenure of HUD Secretary Andrew Cuomo, both of Maryland's Senators spoke with HUD's new Secretary, Mel Martinez, about the problem. As a result of these discussions, Secretary Martinez appointed Maggiano to coordinate HUD's response to the problems in Baltimore. The agency is currently considering policy and regulatory changes that would make properties that have been sold within a specific time period ineligible for FHA insurance.

Throughout the Clinton Administration, HUD was made aware on numerous occasions of these problems and vulnerabilities in its FHA program, and of the Department's faulty oversight of mortgage programs. Instead of cracking down on poor performing lenders, however, the agency did little or nothing to stop such abuses. The unfortunate result of this failure is that unscrupulous sellers, effectively subsidized by FHA-backed loans, made property-flipping victims out of many of the very people whom HUD's program was supposed to help attain the American dream of homeownership.

The victims of property flipping depended on HUD to protect them from the predatory sales and lending practices revealed by the Subcommittee's investigation. Unable to obtain the conventional mortgages needed to buy their homes, these low-income Americans had no alternative but to turn to FHA-supported programs in order to gain any access to the housing market. HUD has a duty to protect such home buyers and to help keep them from becoming the victims of fraudulent sales and lending practices. HUD also has an obligation as to safeguard the integrity of the insurance fund, which could be imperiled should sloppy oversight of loan-guarantee practices leave the fund responsible for covering the cost of many millions of dollars' worth of bad loans. Unfortunately, HUD failed, under the Clinton Administration, to fulfill these responsibilities. Moreover, the Department mischaracterized the assistance it was able to provide to those home buyers who fell victim

[2] Hearing record, *supra,* at 45.

to fraudulent practices in the poorly-overseen lending environment that HUD had for so long permitted to exist. America's low-income home buyers deserved better, and it is gratifying to see Secretary Martinez and other senior HUD officials taking an active role in overseeing efforts to fix these problems.

I. *Introduction*

A. *What is Flipping?*

The Subcommittee's investigation has exposed a national problem with "flipping,"[3] which is a highly complex phenomenon involving multiple players who conspire to defraud home buyers, lenders, and—in the case of Federal Housing Administration (FHA)-backed loans—the Federal Government itself. Flipping involves the purchase and quick resale of homes at a huge price mark-up, often accompanied by little (or only cosmetic) work to improve the properties, in order to create the false illusion of a robust real estate market through the use of phony paperwork and deceptive sales pitches. Flipping poses significant risks to low-income, first-time home buyers, and may affect the overall stability of local neighborhoods.

In a typical "flipped" transaction, an investor purchases a dilapidated house in a marginal neighborhood. This investor then makes cosmetic and temporary improvements to the house, such as carpeting over rotting wood floors or painting over termite damage. At this point, the investor teams up with a realtor who markets the house as a "total rehab" property—as, at first glance it may appear to be—to a first-time, unsophisticated, low-income home buyer. The realtor persuades the buyer to trust him by repeatedly assuring the buyer that he will handle all aspects of the sale on the buyer's behalf and may persuade the buyer to save money by declining to obtain a home inspection, to retain counsel, or otherwise to protect himself. If the buyer questions the value of the house, the investor and realtor can simply point to a deliberately inflated appraisal apparently showing that the house indeed was worth the asking price.

Having gained the trust of the purchaser with the help of such misrepresentations, the realtor then steers the buyer towards a lender with whom the realtor also has "an arrangement." This lender arranges for the buyer to obtain a mortgage loan—sometimes through manipulation of the buyer's financial information or the acceptance of phony gift letters documenting non-existent down payments. Finally, the investor and realtor may themselves retain an attorney to represent the buyer at the closing. Instead of protecting the buyer's interest, however, this attorney's function is to reassure the buyer of the legitimacy of the transaction, and convince him to sign all of the closing documents.

After the buyer moves into the house, of course, he discovers that the "total rehab" is in fact a crumbling relic. The buyer is forced

[3] In its consumer education materials, the Federal Trade Commission (FTC) uses the term "loan flipping" to describe a slightly different predatory lending practice. The term "loan flipping," as it is defined by the FTC, denotes a lender's practice of encouraging a borrower to repeatedly refinance his loan, often to borrow more money. Each time the borrower references, of course, he pays additional fees and interest points, which ultimately increase the borrower's debt.

to make repairs and simultaneously struggle to make monthly mortgage payments on a property, the actual value of which is significantly less than the mortgage itself. The end result for the buyer is often default and, ultimately, the loss of his home through foreclosure. In the end, the buyer is left with no house and a tarnished credit rating, while the neighborhood is left with a vacant, deteriorating house. The flippers, by contrast, collect the profit from the sale of the house at an unjustifiably inflated price after having made only a modest or nominal investment.

Although the purchase and quick resale of a house at an increased price is not itself unlawful, the above scenario illustrates how this practice can cross the line into illegality when documents are falsified and misrepresentations made in order to lure buyers and lenders into investing more money in a house than it is actually worth. Flippers who get FHA backing for their buyers' mortgages, moreover, are able to encourage lenders to put up the full amount of the loan, confident that if the buyer defaults, the government will bail them out. Lenders, appraisers, and other parties who are guilty of such practices may be barred by the U.S. Department of Housing and Urban Development (HUD) from participating in federally financed or insured business. In order to be barred, however, they first have to be caught.

B. *FHA's Single Family Insured Program*

FHA's program for insuring loans for the purchase of single-family housing involves a number of elements, and operates according to criteria as follows:

- *Eligible Loan Purposes:* FHA-insured loans may be used to purchase single-family detached homes, town homes, row houses, two-to-four family buildings, manufactured homes and lots, and condominiums in developments approved by FHA. Loans may also be used to: Build a home; to repair, alter, or improve a home; to refinance an existing home loan; to purchase and improve a home simultaneously; or to install a solar heating and cooling system or other weatherization improvements.[4]
- *Borrower Eligibility:* FHA-insured loans are available to owner-occupants who can demonstrate the ability to repay them according to the terms of the contract. Parties who are in default on previously FHA-insured loans are not eligible for new loans unless this default is cleared or the borrower can show that the default was caused by circumstances beyond his control. Likewise, persons who have previously defaulted on non-FHA insured loans are not eligible for FHA-insured loans.[5]
- *Maximum Mortgage:* Mortgage limits for FHA-insured loans are set on an area-by-area basis. The limits are indexed to the lesser of two benchmarks: The median home price for the area, or the size of loans that may

[4] Bruce E. Foote, Housing Analyst, Domestic Social Policy Division, Congressional Research Service, *FHA Loan Insurance Program: An Overview,* Order Code RS20530 (March 30, 2000), at 4.

[5] *Id.* at 2.

be purchased by the Federal Home Loan Mortgage Corporation (commonly known as Freddie Mac).

The maximum mortgage limits for FHA-insured loans are 87 percent of the Freddie Mac limits. (Since the Freddie Mac loan limits may change at the beginning of January each year, the FHA mortgage limits may also change annually.) As of January 1, 2001, the mortgage limits for FHA-insured loans are $239,250 for one-family properties, $306,196 for two-family properties, $370,098 for three-family properties, and $459,969 for four-family properties. Mortgage limits for loans in Alaska, Guam, Hawaii, and the Virgin Islands may be adjusted up to 150 percent higher. Freddie Mac limits determine the upper and lower FHA limits while the median home price often determines the actual FHA limit for a given area.[6]

- *Loan Term:* FHA-insured loans may be obtained for mortgages with terms of up to 30 years. In special cases, low-income borrowers may be eligible for 35-year loans to make the mortgage more affordable.[7]
- *Down payment:* In general, the down payment is 3 percent of the first $25,000 of the property value, 5 percent of the value between $25,000 and $125,000, and 10 percent of the value in excess of $125,000.[8]
- *Owner Occupancy:* Generally, for loans closed on or after December 15, 1989, borrowers must intend to occupy the property as a principal residence. FHA may sell property that it has acquired as a result of default or foreclosure to either owner-occupants or to investors. (In some cases, those borrowers may obtain FHA-insured loans.)[9]
- *Program Funding:* The FHA home mortgage insurance program is funded by the MMIF, which in turn is funded by the payment of FHA mortgage insurance premiums, interest earnings, and proceeds from the sale of homes that have been acquired through foreclosure on FHA-insured loans. The MMIF is authorized to fund all operations of the mortgage insurance program, including administrative costs.[10]
- *Interest Rates:* The interest rate on FHA-insured loans is negotiated by the borrower, seller, and lender. The borrower has the option of selecting either a loan with an interest rate that is fixed for the life of the loan, or a loan on which the rate may be adjusted annually, known as adjustable rate mortgages (ARMs).[11] The number of ARMs that FHA may insure in a single year,

[6] *Id.* at 2–3.
[7] *Id.* at 3.
[8] *Id.*
[9] *Id.* at 3–4.
[10] *Id.* at 4.
[11] *Id.* at 5.

however, is limited to 30 percent of the total number of mortgages insured under FHA's program for conventional housing loans during the preceding fiscal year.[12] The interest rate for ARMs may be adjusted annually by a 1 percent increase or decrease from the rate in effect during the preceding year, with a lifetime change of a 5 percent increase or decrease from the rate reflected on the note.[13]

- *Underwriting Guidelines:* FHA-insured loans must be underwritten in accordance with the accepted practices of prudent lending institutions and FHA requirements. The FHA credit analysis worksheet is used to examine the applicant's personal and financial status, monthly shelter expenses, funds required for closing expenses, effective monthly income, and debts and obligations. As a general rule, the applicant's prospective housing expenses should not exceed 29 percent of his or her effective monthly income. The applicant's total obligations, including proposed housing expenses, should not exceed 41 percent of gross effective monthly income. Credit is automatically denied to applicants whose credit report indicates a delinquency of 90 days or more on a non-FHA-insured loan, or foreclosure on such a loan in the past 3 years.[14]
- *Credit Limits:* The volume of FHA insurance commitments is subject to a fiscal year ceiling set by Congress. During fiscal year 2000, FHA was permitted to make insurance commitments totaling no more than $140 billion.[15]
- *Reimbursement of Lenders:* FHA reimburses 100 percent of the unpaid principal balance of a FHA-backed mortgage as of the date of default, as well as any costs or fees that may accrue during the time the lender must spend disposing of the property.[16]
- *Program Activity:* During fiscal year 1999, FHA underwrote $113.2 billion in insurance to insure the purchase or refinancing of 1,219,928 housing units. At the end of fiscal year 1999, FHA had $411.5 billion in insurance in force. From its inception in 1934 through the end of 1999, FHA has insured nearly 27.9 million home loans at a mortgage volume of about $1,258 trillion.[17]

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[12] FHA is funded under two statutory titles of the National Housing Act (12 U.S.C. 1703). Title I is funding for loans for mobile homes and improvements. Title II is funding for all other FHA programs. Subcommittee staff telephone interview with Judy Heaney, community Builder, U.S. Department of Housing and Urban Development (June 16, 2000).

[13] U.S. Department of Housing and Urban Development, Mortgagees' Handbook, 4000.2 REV–2, Chapter 6, Section 6–20, at 6–22, 6–23 (July 1991).

[14] Foote, *supra,* at 5.

[15] *Id.*

[16] *See* 24 CFR § 203.402.

[17] Foote, *supra,* at 5.

C. *Overview of PSI's Investigation*

The Subcommittee began this investigation with the establishment of a preliminary inquiry in September 1999, pursuant to Rule 1 of the Subcommittee Rules of Procedure. The objective of this preliminary inquiry was to evaluate the scope and nature of the mortgage flipping problem across the country. The Subcommittee's work thus built upon the efforts enforcement agencies and an investigation by *Baltimore Sun* reporter John O'Donnell, who is widely credited with exposing the problem of flipping in Baltimore. Since that time, Subcommittee staff members have interviewed more than 100 witnesses, including home buyer victims, real estate brokers, lenders, and attorneys involved in mortgage flipping cases, as well as government officials, community activists, and other stakeholders. In addition, Subcommittee staff reviewed hundreds of records documenting specific property flips. These investigative efforts confirmed that the phenomenon of flipping is not simply a local, State, or even regional problem, but rather is a Nation wide crisis.

II. *The "Players" in a Flipping Transaction*

A. *Lenders*

Lenders must obtain approval from HUD to participate in FHA's mortgage programs. In addition to an application form and fee, lenders must submit to HUD documentation showing that they meet FHA's requirements for lending experience, financial worth, and adequacy of facilities. As of December 1999, approximately 9,950 lending institutions had been approved to participate in FHA's mortgage insurance programs for single-family homes. Most of these lenders are authorized only to *originate* FHA-insured loans, meaning that they can accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process. Approximately 2,900 of the FHA-approved lending institutions, however, have so-called "Direct Endorsement" (DE) authority [18] in addition to loan origination authority. Such lenders can underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review.[19]

Prior to 1983, FHA staff reviewed and approved, or "underwrote," most loans prior to insurance endorsement. In 1983, FHA delegated DE authority to approved lenders. As a result, lenders with Direct Endorsement authority became responsible for virtually all aspects of the loan origination, underwriting, and closing process.[20] HUD describes DE as the mechanism that enables HUD/FHA-approved lenders to consider single-family mortgage applications without first submitting paperwork to HUD, thereby enabling

[18] Direct Endorsement is authorized under § 203(b) of the National Housing Act, codified at 12 U.S.C. § 1709(b),(1). Program regulations are located at 24 C.F.R. §§ 203.5 and 203.255. The program is administered by HUD's Office of Housing-Federal Housing Administration. *See* U.S. Department of Housing and Urban Development, *Direct Endorsement* (visited June 13, 2000), **http://www.hud.gov.progdesc/direct-r.html** [hereinafter, "HUD, *Direct Endorsement"*] at 2.

[19] U.S. General Accounting Office, GAO/RCED–00–112, *Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk* (April 28, 2000), at 7–8.

[20] Office of the Inspector General, U.S. Department of Housing and Urban Development, Audit Report # 00–SF–121–001, *Single Family Production Home Ownership Centers* (March 30, 2000) [hereinafter "HUD/OIG, *Single Family Production Home Ownership Centers"*], at 1.

FHA-insured mortgages to be processed as rapidly as other mortgages.[21]

The DE underwriting and endorsement process requires the lender to determine that a property is acceptable for mortgage insurance by completing an analysis of the property to determine its eligibility for endorsement and the maximum mortgage amount. The lender must also complete a credit analysis of the borrower to determine his or her creditworthiness. An underwriter must review the appraisal report and mortgage credit analysis, and then certify or approve the loan package itself. The lender must execute a "mortgagee's certification" to HUD stating that:

> "I, the undersigned, as authorized representative of ————, mortgagee, at the time of closing of this mortgage, certify that I have personally reviewed the mortgage loan documents, closing statements, application for insurance endorsement, and all accompanying documents. I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4."[22]

The lender then submits the loan case binder to HUD, which conducts a pre-endorsement review of the binder. This pre-endorsement review concludes with endorsement of the mortgage for an acceptable submission through completion of a "Mortgage Insurance Certificate," which it issues to the lender.[23] After insurance endorsement, HUD reviews select properties and mortgage credit analyses through the post-endorsement technical review and on-site lender review processes described below. Theoretically, the percentage of such cases reviewed depends upon the quality of past underwriting and servicing problems on earlier loans.[24]

Lenders have an obvious and significant financial interest in loan approval. In order to limit the risks inherent in transferring so much responsibility to lenders, FHA implemented new procedures to monitor Direct Endorsement lenders, primarily through pre-closing status reviews, pre-endorsement loan screening, post-endorsement technical review, and on-site lender monitoring.[25] Such evaluation tools fall into four basic types, as follows:

- *Pre-closing reviews:* When new lenders apply for DE approval, they are initially placed on "pre-closing" status. This means that HUD reviews their loan packages prior to closing to determine whether the lenders have the capacity to originate and underwrite loans properly in accordance with FHA guidelines.[26]
- *Pre-endorsement loan screening:* Endorsement contractors working for HUD are required to ensure that FHA loan file documents are both accurate and complete

[21] HUD, *Direct Endorsement, supra,* at 1.
[22] U.S. Department of Housing and Urban Development, *Single Family Direct Endorsement Program,* 4000.2, at Appendix 4 (Mortgagee's Certifications).
[23] HUD, *Direct Endorsement, supra,* at 1.
[24] U.S. Department of Housing and Urban Development, Handbook 4000.4 REV–1, *Single Family Direct Endorsement Program,* Chapter 1 (December 1992), §1–2, at 1–1, 1–3, and 1–4. (For an examination of the adequacy of HUD oversight of high-risk loans and lenders, *see infra,* at Part V.)
[25] HUD/OIG, *Single Family Production Home Ownership Centers, supra,* at 1.
[26] *Id.* at *v.*

prior to issuing Mortgage Insurance Certificates to the originating lenders.[27] The contractors basically determine that certain key loan documents are in the file prior to insurance endorsement. The contractors must also verify the accuracy of certain loan information as included in the loan file documents and as input into HUD's automated system by lenders. The contractors are required to verify that some loan documents are in every file, while other loan documents—such as gift letters—are only required under certain circumstances.[28]

- *Post-endorsement technical review:* This involves reviewing a sample of cases after insurance endorsement in order to ensure compliance with HUD underwriting and appraisal requirements.[29]
- *On-site lender monitoring:* HUD's Quality Assurance Divisions perform on-site monitoring reviews, also called field reviews, of Direct Endorsement lenders to identify and correct poor origination practices.[30]

B. *Appraisers*

FHA originally required appraisals to be an independent check on the value and condition of the property for which a borrower was seeking an FHA-insured mortgage. Until 1994, for each proposed mortgage, HUD selected, on a rotational basis, an appraiser from HUD's FHA "Appraiser Fee Panel" to appraise the property.[31] To be placed on this panel, HUD required appraisers to demonstrate a high level of experience and be knowledgeable about the appraisal process and property standards that homes being considered for FHA-insured mortgages must meet. HUD closely monitored Fee Panel appraisers by field reviewing at least 10 percent of their appraisals yearly. In addition, HUD trained Fee Panel appraisers in order to ensure that homes for which FHA insurance was being sought were safe, sound, and sanitary.[32] Under this system, the lender completed an "Application for Property Appraisal and Conditional Commitment," and then contacted its local HUD office to receive a case number and the name of an appraiser.[33]

In December 1994, HUD implemented regulations mandated by 1990 amendments to the National Housing Act that transferred appraisal selection responsibilities from FHA staff to Direct Endorsement lenders.[34] Under this system, which is commonly known as the "Lender Select" appraisal system, HUD disbanded the list of

[27] *Id.*
[28] HUD/OIG, *Single Family Production Home Ownership Centers, supra,* at 51–52.
[29] *Id.* at *iv.*
[30] *Id.*
[31] Prior to 1994, HUD-approved appraisers were referred to as "Fee Appraisers," and the list of HUD approved appraisers was referred to as the "Fee Appraiser Panel."
[32] Subcommittee staff telephone interview with James Smith (June 6, 2000); Subcommittee staff telephone interviews with Frank DiGiovanni (May 17–18, 2000).
[33] U.S. Department of Housing and Urban Development, *Mortgagees' Handbook,* 4000.2, Chapter 2, § 1–10 (July 1991), at 2–5.
[34] In 1988, when asked why lenders should be allowed to select their own appraisers for liability-free HUD insured mortgages, Representative Barnard (D–GA) responded that "[t]he lender wanted to have as much control of the transaction as possible—which included the appraiser." Frank DiGiovanni, *Chronological History of Appraisal in the Chicago Area, Including HUD/FHA Data,* (received May 23, 2000).

HUD-approved appraisers and delegated responsibility for selecting them to the Direct Endorsement lenders themselves.

The DE lenders are now allowed to select any appraiser licensed by the State in which he practices.[35] According to one appraiser, this delegation has permitted lenders discretion to employ the least-qualified appraisers for their FHA-backed mortgages.[36] (In Illinois, for example, an apprentice appraiser with little experience is nevertheless licensed.) The lender discretion permitted by the Lender Select program, it appears, has also encouraged real estate agents to pressure lenders to choose certain appraisers—and not others—to evaluate their properties, too often thereby obtaining appraisals of sub-par properties at inflated values.[37] One appraiser interviewed by Subcommittee staff also opined that in his experience, it was not unusual for banks to request that the appraised value of a property be increased.[38]

Overall, the results of the Lender Select program have been less than satisfactory. A 1999 report by the General Accounting Office (GAO) found that "HUD was not doing a good job of monitoring the performance of appraisers"[39] and "is not holding appraisers accountable for the quality of their appraisals."[40] The report concluded that "HUD has not aggressively enforced its policy to hold lenders equally accountable with the appraisers they select,"[41] and that "HUD has limited assurance that the appraisers on its roster are knowledgeable about FHA's appraisal requirements."[42]

C. *Inspectors*

FHA does not presently require home buyers to obtain a home inspection as a prerequisite to obtaining an FHA-backed mortgage, nor has it ever required that they do so. Prior to 1996, FHA provided home buyers with advisories regarding interest rates, discount points, loan fraud, and lead-based paint. In December 1996, FHA announced that it would begin highlighting the need for home buyers to obtain home inspections through distribution of a separate form entitled, "Importance of Home Inspections." This form explained to the buyer the benefits of arranging for a professional inspection of the home, but also advised that "[t]here is no requirement that you hire an inspector." (FHA required the buyer to sign and date this form on or before the date of execution of the sales contract, but it did not require retention of the form in the FHA endorsement binder.)

In June 1998, FHA announced as part of its Homebuyer Protection Plan that it would replace the "Importance of Home Inspections" form with a new form entitled "For Your Protection: Get a Home Inspection." This updated form advises the buyer that FHA

[35] Subcommittee staff telephone interview with Frank DiGiovanni (May 27, 2000).
[36] *Id.*
[37] *See* Bill Rumbler, *Shady Deals Alleged in FHA Appraisal System,* Chicago Sun-Times (September 28, 1997).
[38] Subcommittee staff interview with Robert Skovera in New York City, N.Y. (June 8, 2000). Skovera said that it was impossible to accommodate some of the requests he received were impossible because the property did not justify the specified increase.
[39] U.S. General Accounting Office, GAO/RCED–00–112, *Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process* (April 16, 1999) [hereinafter, "GAO, *FHA Appraisal Process"*], at 2.
[40] GAO, *FHA Appraisal Process, supra,* at 2.
[41] *Id.* at 3.
[42] *Id.* at 3.

does not guarantee the value or condition of the property; that an appraisal is not the same thing as a home inspection; and that the borrower has the right to have the house inspected by a professional home inspector. (In contrast to the previous form, this new form must be retained in the FHA insurance endorsement binder.) FHA also allows home buyers to finance at least a portion of the cost of a home inspection through the FHA-backed mortgage that they obtain.

On May 12, 1999, Representative Rick Lazio (R–NY) introduced H.R. 1776, the American Home Ownership and Economic Opportunity Act of 2000. This bill, among other things, would require GAO to conduct a study regarding the inspection of properties purchased with FHA-backed mortgages. The proposed study would evaluate such issues as: The feasibility of requiring inspections of all properties purchased with FHA-insured loans; the monetary impact of such a requirement on the FHA insurance fund and home buyers; and the impact of mandatory inspections on the process of buying a home. This bill passed the House by a 417–8 vote on April 6, 2000, and was referred to the Senate Committee on Banking, Housing, and Urban Affairs. Although the Banking Committee passed some of the portions in the bill, the mandatory inspection provision was not.

III. *The Nationwide Scope of Flipping*

To illustrate the truly nationwide epidemic that is flipping, Subcommittee staff developed case studies of various flipping schemes in cities throughout the United States. These case studies provide a glimpse of how such frauds are perpetrated as well as the financial and emotional toll that often results.

A. *New York City: The Story of Lisa Smith*

(1) *Victim of Mortgage Flipping*

Lisa Smith is a New York City police officer and a single mother of three who sought to move her family out of their apartment and into a house. She testified before the Subcommittee on the first day of its flipping hearings.

Smith was a first time home buyer when she responded to an advertisement in a local newspaper by Lenders Realty, a real estate agency specializing in the sale of foreclosed properties. The former manager of Lenders described it as being a speculative business that acquired houses, primarily foreclosures, for investment purposes. After purchasing the houses, the former manager said, Lenders would renovate and sell them.

After Smith contacted Lenders, its representatives showed her a house located at 145–08 123rd Avenue in the Queens neighborhood of South Ozone Park. Lenders representatives, whose names Smith cannot recall, told Smith that the house had been completely renovated during the 3 years it had been vacant. They also told Smith that they would assist her with everything related to the closing of the property. When Smith expressed concern about her lack of understanding of the process of purchasing a house to the Lenders representatives, all of whom were women, they told her that she could trust them because they would not deceive another woman. After Lenders representatives showed her the house, they informed

her that if she did not enter into a contract immediately, the house would be sold to another buyer.[43]

On May 5, 1997,[44] Smith duly signed a sales contract to purchase the house for $129,000. The seller, AllBorough Inc., had purchased the property in December 1996—only 5 months previously—for merely $50,000. Significantly, Smith's sales contract contained an "as is" clause declaring that Smith had inspected the property, was thoroughly acquainted with its condition, and agreed to purchase it in that present condition.[45] The contract also stated, however—somewhat inconsistently—that the seller agreed to pay for all necessary repairs. (According to Smith, no such payments for repair ever occurred.)

Smith's contract and its rider also contained clauses regarding title inspections and the purchaser's right to have a termite inspection. Smith signed a form advising her of the importance of a home inspection; she did not, however, check either of two boxes appearing on the form indicating that she intended to have a home inspection or waive this right. Smith did not obtain an inspection of the house because Lenders representatives told her that Lenders had already paid for an inspection, which had revealed that the house was in good condition.[46] This apparently was not true. The former manager of Lenders told Subcommittee staff that it was not part of the company's business practice to have inspections performed, and that Lenders routinely arranged only for appraisals of properties it sold—not inspections.[47] (Furthermore, Robert Skovera, who had appraised Smith's property at the request of her lender, told Subcommittee staff that if Lenders had characterized his appraisal as a home inspection, that would have been a misrepresentation.[48])

As a New York Police Department (NYPD) employee, Smith is entitled to receive free legal services from the Police Benevolent Association (PBA). However, Lenders representatives falsely told Smith that the PBA attorney whom she had arranged to represent her at the closing had disparaged her, thereby persuading Smith to replace this attorney with someone *Lenders* selected for her, an attorney by the name of Goodman. Goodman, Lenders representatives informed Smith, would represent her during the homebuying process free of charge. According to Smith, the lawyer repeatedly assured her that he was acting in her best interest. When she tried

[43] Telephone interview with Lisa Smith (June 15, 2000).

[44] The appraiser who valued Smith's house at this price did not specifically remember appraising her house. However, he recalled that Smith's lender, Alliance Mortgage Banking Corporation, had in the past asked him to increase the appraised value of properties. He did not consider Alliance, however, to be one of the worst offenders in this respect: Some other lenders were worse. Subcommittee staff interview with Robert Skovera in New York City, N.Y. (June 8, 2000).

[45] At least one court has noted that the days of caveat emptor in real estate are gone. *See Gibb v. Citicorp Mortgage, Inc.,* 518 N.W.2d 910, 918–19 (Neb. 1994). The Subcommittee staff's review of case law evaluating real estate sales contracts containing "as is" provisions suggests a recent weakening of the protection such clauses bestow upon the property seller, particularly where a sale has been predicated on fraud or misrepresentation. Furthermore, "as is" clauses are standard, boilerplate inclusions in real estate contracts for the purchase of existing houses, and it is unlikely that Smith would have been able to sign a contract that did not contain the clause. *See, e.g.,* Subcommittee staff telephone interview with Charles Dale, Congressional Research Service (May 9, 2000).

[46] Subcommittee staff interview with Lisa Smith in New York City, N.Y. (June 8, 2000).

[47] Subcommittee staff interview with Howard Krin in New York City, N.Y. (June 8, 2000).

[48] Subcommittee staff interview with Robert Skovera in New York City, N.Y. (June 8, 2000).

to ask him questions about the sales contract, however, he told her not to worry and to sign the document.[49]

In connection with the purchase of the house, Smith signed a gift affidavit representing that Bernard Tadell, which the affidavit described as a cousin of Smith, would provide her with $4,100 in gift money at the closing to use in the purchase of the house. In fact, Tadell is not Smith's cousin, but rather the father of two of her children. He also did not give her any money for use in the purchase of the house.[50] Smith explained to Subcommittee staff that a Lenders representative gave her a blank affidavit to sign, and told her that all home buyers receiving FHA insured mortgages must sign such gift letters as a mere formality. Smith's new attorney, Goodman, was present during this exchange. Smith asked him if it was permissible for her to sign the affidavit, and he assured her that it was. (Additionally, one of the female Lenders representatives reassured Smith that completing the form was not illegal.) Smith thus took the affidavit to Tadell and asked him to complete it. He did so, but, at Lenders' direction, left the dollar amount blank. Smith also signed the gift affidavit, then returned it to Lenders.

In retrospect, Smith wishes she had not signed the affidavit, but contends that she did so because she felt that her lawyer would not instruct her to break the law.[51] In addition, it is noteworthy that when Subcommittee staff provided Smith with a copy of the gift affidavit, she was surprised that the affidavit did not reflect her recollection of its contents. She recalled that Lenders representatives had told her that the purported gift amount would be limited to between $500 and $1,000, not the $4,100 that is listed on the affidavit (and was apparently added after she and Tadell had both signed it). Furthermore, she did not recognize the handwriting on the affidavit apart from Tadell's signature itself, and the bank account information listed on the document was fictitious.

In July 1997, Smith closed on the house. Lenders arranged for Alliance Mortgage Banking Corporation to finance Smith's mortgage,[52] which was guaranteed by the FHA. No one ever explained the different types of mortgages available to her. (When Subcommittee staff first interviewed Smith, she had no idea what "FHA" meant despite having obtained an FHA-backed mortgage.) Although her attorney, Goodman, represented Smith at the closing, his principal role was simply to urge her to sign all of the closing documents; he was of no help in explaining what she was signing.

Not surprisingly, Smith encountered numerous problems after moving into the house. The basement flooded constantly and raw sewage backed up into the house. Smith called Lenders several times to complain about this problem, but she never received any response. When Smith gave Subcommittee staff a tour of the house, the odor in the basement was overwhelming due to this constant problem of sewage flooding. A contractor she consulted informed her that the problem was essentially unfixable. Moreover, the roof

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[49] Subcommittee staff interview with Lisa Smith in New York City, N.Y. (February 1, 2000).
[50] Subcommittee staff telephone interview with Lisa Smith (June 12, 2000).
[51] *Id.*
[52] The Subcommittee's investigation has revealed that Lenders ceased operating in January 2000.

of the house leaked, inadequate insulation resulted in her having to pay monthly heating bills of between $400 and $500, the siding needed replacement, and the floor was falling apart. Smith was particularly upset about problems with the windows in the house because Lenders representatives had told her that they were brand new. After moving in, however, she discovered that they were not; in fact, she was forced to cover the windows with plastic because of the cold drafts they let in during the winter.[53]

Smith could not afford to make the repairs necessary to render this decaying house habitable despite her attempts to do so by obtaining two additional loans: In May 1998 from The Money Store for approximately $12,000 at an interest rate of 11.49 percent, and the second in February 1999 from Madison Home Equities for approximately $45,000 at an interest rate of 14.21 percent. Ultimately, Smith could not afford to continue making the payments on her mortgage as well as on these additional loans. On advice from her new PBA counsel, therefore, she stopped making mortgage payments in December 1999 and, in March 2000, abandoned the house altogether. Smith has moved her family back into an apartment. As a result of her resulting financial situation, she has declared bankruptcy. Smith has also been served with a summons for defaulting on the first of her three mortgages.[54]

Lisa Smith's case highlights the typical elements of a mortgage "flipping" case. Although Smith is a police officer with an associate's degree in liberal arts from LaGuardia Community College in New York, she was by no means a sophisticated home buyer, and was unable to navigate the complex financial transaction of buying a house without guidance. Nor did she know that, as a general matter, prospective home buyers hire their own representatives to protect their interests. This naiveté rendered her vulnerable to the high pressure tactics—and outright deception—employed by Lenders, Alliance Mortgage Banking Corporation, and attorney Goodman, whom Lenders itself selected to represent her.

To make matters worse, Smith was at that point in her life particularly vulnerable. She had recently terminated what she described as an abusive relationship with the father of her youngest child. This relationship had caused tremendous emotional distress for Smith and her children, and while she was trying to purchase a house, her family was undergoing counseling and trying to put the pieces of their lives back together. Smith wanted to be able to prove to herself that she could increase the quality of life for her family. Smith's confusion and her reliance upon the ostensible "professionals" at Lenders, Alliance, and in the form of attorney Goodman thus contributed to her victimization at their hands.

(2) *Problems of HUD Oversight*

Unfortunately, inadequate oversight by the U.S. Department of Housing and Urban Development also played a role in this story. A preliminary review of Alliance Mortgage Banking Corporation's records reveals that its foreclosure rate is notably higher than New York State's average foreclosure rate. HUD's Office of Lender Activities, in fact, determined that 7 percent of Alliance's loan origi-

[53] Subcommittee staff interview with Lisa Smith in New York City, N.Y. (February 1, 2000).
[54] Subcommittee staff interview with Lisa Smith in New York City, N.Y. (May 5, 2000).

nations default within the first year—nearly double the 3.62 percent average for New York State.[55] (The FHA national average foreclosure rates for the first three quarters of 1999 was even lower: 2.20 percent.[56]) While Subcommittee staff were unable to determine what percentage of Alliance's foreclosures occurred on FHA-insured loans, there were clear red flags that should have suggested to HUD that Alliance might be a problem. HUD should have scrutinized more closely the loans made—on its behalf, and with its guarantee—by a lending institution with such a poor foreclosure record.

During the hearing, Senator Collins asked Ms. Smith how she chose the lending institution:

> "Q: How did you select the bank for your mortgage?
> A: I didn't select a bank. Lenders selected the bank."[57]

(Lenders' affinity for Alliance may, in fact, derive from more than simply a shared interest in taking advantage of home buyers such as Lisa Smith. Subcommittee staff were advised by Robert Skovera, Smith's appraiser, that the former owner of Lenders is also a principal at Alliance Mortgage Banking Corporation. Subcommittee staff has so far been unable to confirm this allegation, however.)

FHA uses several formulas to assess whether a borrower should qualify for an FHA-insured mortgage. For example, an applicant's prospective housing expenses should not exceed 29 percent of gross monthly income. Smith's gross monthly income was $3,632.75. Her mortgage payment was $1,061.41, however, which totaled 29.218 percent of her gross monthly income—that is, just above the threshold that should suggest problems under FHA's guidelines. Smith had an adjustable rate mortgage, moreover, so while she only just exceeded the 29 percent level at the outset, any increase in mortgage interest rates would have pushed her increasingly into the danger zone.[58]

Moreover, pursuant to FHA guidelines, credit should automatically be denied to applicants whose credit report indicates a delinquency of 90 days or more on a non-FHA insured loan. While Smith's report does not reflect a delinquency in excess of 90 days, the report does indicate that she might well be a credit risk. Specifically, it noted: "Serious delinquency; derogatory public record or collection; proportion of revolving balances to revolving credit limits is too high; frequent delinquency."[59]

All in all, therefore, Smith thus fell into the category of prospective home buyers who barely meet the FHA guidelines and whose loan applications, if predicated on a adjustable rate mortgage, should be evaluated on the basis of potential future increases to minimize foreclosures. Ordinarily, therefore, a lender would have approached her mortgage with great caution—or have simply refused to loan her the money needed to make this purchase. Be-

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[55] *See* Office of Lender Activities, U.S. Department of Housing and Urban Development, *Review of Alliance Mortgage Banking Corporation* (June 25, 1999).

[56] *See generally* HUD/OIG, *Single Family Production Home Ownership Centers, supra.*

[57] Hearing record, *supra,* at 21.

[58] Pursuant to FHA guidelines, the applicant's total obligations—including proposed housing expenses—should also not exceed 41 percent of monthly gross income. Smith's monthly obligations were calculated by the underwriter to be $1,248.41, however, or 34.365 percent of her gross monthly income.

[59] Credit Decisions, Inc., report prepared for Alliance Mortgage Banking (May 5, 1997).

cause FHA backed the loan, however, there was no risk to the lender, freeing it to become a costless participant in the mortgage flipping fraud perpetrated against Smith—with the Federal taxpayer picking up the tab when bankruptcy and foreclosure overtook her.

B. *Chicago: The Easy Life Realty Story*

Subcommittee staff interviewed eight Chicago home buyers, each of whom purchased a home from either a real estate agency known as Easy Life Realty (ELR) or Ace Realty, its successor. Richard Nelson and Louis Prus owned both businesses. Prus and Nelson began working together in the early 1970's by forming the Easy Life Real Estate and Management System, Inc., with the intention of managing and selling properties owned by others. In the 1980's, they began to acquire, renovate, and sell houses that needed only cosmetic repairs. In the 1990's, they began to acquire distressed properties that needed much more rehabilitation, such as replacement of mechanical systems, before they could be sold. Nelson and Prus referred to this as their "REO," or Real Estate Owned, program. One of Prus's goals was for ELR to become the dominant real estate agency in each of several specific ethnic markets. At its peak, ELR employed a sales force numbering between 40 and 50 salespersons.

ELR acquired properties through its sales force. A salesperson would locate and purchase a dilapidated property on ELR's behalf using funds approved by Nelson. Prus and Nelson claim that the salesperson handled everything from planning and implementing the rehabilitation work to marketing and selling the property. (ELR's role, he said, was merely to finance the venture.) Upon the sale of the property, the salesperson accordingly earned a large percentage of the profit, usually 40 percent. Unfortunately, because the salesperson had to cover any rehabilitation costs out of his anticipated share of the profit, this arrangement provided the salesperson with powerful incentives to minimize rehabilitation costs. (In some cases, in fact, it may have led salespersons actually to supply down payment money to prospective purchasers who would otherwise not qualify for a mortgage, thus helping the salesperson reap his percentage of the sale—although Nelson and Prus profess ignorance regarding this practice.) Nor did ELR bother to obtain building permits for the rehabilitation work it conducted on the properties the Subcommittee examined. As a result, the City of Chicago conducted no inspections to ensure that the rehabilitation work was done properly, or at all.

In 1996, HUD threatened to bar Nelson and ELR from participating in FHA programs as a result of allegations that ELR had provided funds to purchasers to use as down payments and had falsified documentation. Nelson and ELR entered into a settlement agreement with HUD pursuant to which Nelson paid a $35,000 penalty. In exchange, HUD agreed to permit ELR to continue participating in FHA programs.

A number of the home buyers with whom Subcommittee staff spoke are named plaintiffs in a pending Federal class action against Nelson, Prus, ELR, and Ace. This civil lawsuit, which was filed in August 1997, alleges violations of the Racketeer Influenced

and Corrupt Organizations (RICO) Act, the Fair Housing Act, and the Civil Rights Act, as well as violations of State fraud and consumer protection statutes. The complaint avers that the defendants committed these violations by systematically defrauding residents of the overwhelmingly minority Austin community in Chicago during the last decade through various means, including: Running false and misleading real estate advertising; misrepresenting the condition of the properties that they sold; exerting inappropriate control over plaintiffs' financing for their purchases; discouraging or preventing plaintiffs from obtaining independent attorneys; inspectors or other safeguards in the home purchase process; engaging in inflated pricing; performing or controlling dangerously shabby construction work; and committing outright bank fraud. Some 105 persons have joined the plaintiff class.

Nelson and Prus each asserted their Fifth Amendment privilege against self-incrimination in response to Subcommittee subpoenas compelling their appearances at depositions.

(1) *Stekeena Rollins*

Stekeena Rollins purchased a 95-year-old home located at 130 North Latrobe Street in Chicago along with her mother, Shirley Rollins. Stekeena is a high school graduate who completed some course work at a community college in Chicago. Since graduating from high school, she has worked as a bank teller, in child care, and as a nursing home assistant. She was a 21-year-old single mother when she purchased the house. Like Stekeena, her mother Shirley was also a first time home buyer. Although Shirley had attended 2 years of high school, she did not graduate. Instead, she completed 2 years of trade school, and 3 months of college studying food service. She was 49 years old at the time she bought the house, and had custody of five grandchildren. Her employment history includes jobs at child care facilities, factories, and schools. As of June 2000, Shirley had been unemployed since 1998.

The Rollinses first became aware of ELR in June 1995, when they saw one of its advertisements in the *Chicago Sun-Times* proclaiming, "Kiss Your Landlord Goodbye!" After seeing the advertisement, they visited ELR's office where they met Peter Sandow, a real estate agent. They told him that they wanted to purchase a house large enough to allow Stekeena to operate a day care center from their home. Sandow showed them several homes in the Austin neighborhood of Chicago, but the Rollinses specifically told him that they did not want to live in Austin because of their concerns about local levels of violence and drug activity. Sandow then showed them a house that he said was in Oak Park, an upper-middle class neighborhood adjacent to Austin. This house, which had been converted into two separate flats, had been damaged in a fire, was leaning to one side, and obviously needed a great deal of work. Nevertheless, it was large enough to meet their needs (including their hopes of operating a day care center there), and Sandow assured the Rollinses that pursuant to an unspecified Federal program, ELR would thoroughly rehabilitate the house, pay for an inspection, and provide a lawyer to represent them at closing. Pleased to hear this, the Rollinses relied upon his assurances in deciding to purchase the house. Accordingly, on July 21, 1995, they

signed a contract for the purchase of the house for $119,000, after paying $500 as an "earnest money" deposit.[60]

The purchase contract Stekeena and her mother signed in July 1995 did not include any provisions relating to home inspections. Around the time they signed the contract, however, they also signed a HUD form encouraging them to obtain a home inspection, as well as an Illinois Association of Realtors form advising them of their right to request such an inspection. Stekeena stated both to Subcommittee staff and during her deposition in the pending civil action that, prior to closing, she asked Sandow whether she needed to do anything to finalize the sale of the house. Sandow told her that ELR would supply a lawyer to represent her at closing, an inspection of the home, and an examination of the home by a termite control company. Stekeena relied on his representation that ELR would follow through on these promises, and did not question whether ELR had actually taken any of these steps prior to closing. Moreover, the Rollinses were given a form to sign, entitled "Illinois Association of Realtors: Residential Real Property Disclosure Report" which did not indicate any defects to the property. (The seller of the property also signed this disclosure form; not a single problem was highlighted on it.)

In August, the Rollinses discovered through a family friend that the house was actually located in the Austin neighborhood, not in Oak Park. When Shirley confronted Sandow with this discovery, he replied that they could not renege on their agreement to purchase the house because they were "locked in" as a result of signing the sales contract. He also told her that, if she tried to get out of the sale, she would never get another FHA-backed mortgage.[61]

Just prior to closing, Sandow explained that because the Rollinses were first-time home buyers, the Federal Government would provide them with $6,000 to use as a down payment. To take advantage of this program, Sandow told the Rollinses to enlist the assistance of someone with a bank account whom they could trust. The Rollinses secured the aid of 24-year-old Valencia Lockhart, a family friend. Sandow accompanied Lockhart to the bank, where he gave her $6,000 in cash. At Sandow's direction, Lockhart deposited the cash into her account, then immediately purchased a cashier's check for $6,000 made payable to Stekeena. After the completion of this transaction, Sandow paid Lockhart $50 in cash for her assistance.[62] Lockhart then executed a phony gift affidavit documenting her alleged gift to the Rollinses. Although the Rollinses' signatures appear on this affidavit, they do not remember signing it, and the signatures do not match their signatures on the sales contract or closing documents.

The Rollinses closed on their house on September 29, 1995. At the closing, the Rollinses saw an appraisal valuing their house at $119,000, a termite inspection certificate indicating that there was no visible termite damage, and the results of a roof inspection indicating that the roof was in good condition. The appraisal had been conducted by James Koechle, who was subsequently indicted by a

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[60] Subcommittee staff interview with Shirley and Stekeena Rollins in Chicago, Illinois (March 28, 2000).
[61] Deposition of Shirley Rollins, at 79:13 (December 3, 1999).
[62] Subcommittee staff telephone interview with Valencia Lockhart (June 1, 2000).

Federal grand jury in the Northern District of Illinois on January 26, 2000 for submitting inflated appraisals to mortgage lenders in an unrelated mortgage-flipping scheme.

Documents the Rollinses signed at their closing include a HUD–1 Settlement Statement reflecting a down payment that included the ostensible "gift" from Lockhart. Richard Nelson, co-owner of ELR and owner of the house, signed through his attorney a form called the Addendum to the HUD–1 Settlement Statement. This form certified that Nelson had not paid or reimbursed the Rollinses for any part of the down payment for the purchase of the house—despite the fact that ELR, through Sandow, had provide them with $6,000 through the sham transaction with Lockhart. (The Rollinses also signed this form, thereby falsely attesting that they had not received any cash from the seller for any portion of the down payment.) In addition, the Rollinses signed a form indicating that they understood they were purchasing the house "as is."

Although the Rollinses' signatures on the gift affidavit and the Addendum suggest some level of complicity in the very fraud that victimized them, Stekeena maintains that she relied completely on assurances by Sandow that she was not doing anything inappropriate, that "everybody does it" in this manner, and that this was simply the way houses were *normally* purchased. The lawyer ELR provided to represent the Rollinses at closing, Carl Palladinetti, reinforced these misrepresentations: Rather than providing legal advice, he simply advised them to sign each document placed before them without offering any meaningful explanation of what they were signing.[63] (During her deposition in the civil action, Shirley testified that, at the closing, she also noted about five documents with signatures purporting to be hers which she had not signed. When she pointed this out to the attorney, he responded that she had probably forgotten about it. Then he said, "Anyway, I have a boat to catch," and continued passing papers to her for signature.[64])

Stekeena and her mother obtained an FHA-backed mortgage from a HUD-approved Direct Endorsement (DE) lender[65] called Dependable Mortgage, Inc. This lender, however, was apparently already emerging as a potential problem. Within a few months of the Rollinses' closing, in fact, HUD felt compelled to notify the president of Dependable Mortgage in a letter dated August 1996, that the company's rate of early payment defaults and claims on FHA insured mortgages was in excess of 200 percent of the normal rate. Specifically, with regard to loans endorsed in 1995, as of June 30, 1996, Dependable's overall FHA mortgage default rate was 11.49 percent, while the FHA default rate for lenders under the jurisdiction of the Chicago HUD office was only 2.15 percent, and the national FHA default rate only 2.66 percent.[66] For this reason, HUD advised that it intended to terminate Dependable's authority

[63] Subcommittee staff interview with Stekeena and Shirley Rollins in Chicago, Illinois (March 28, 2000).

[64] Deposition of Shirley Rollins, at 70:14 (December 3, 1999).

[65] A Direct Endorsement lender has the authority to underwrite mortgages for FHA insurance purposes without FHA approval prior to closing.

[66] Letter from Emelda Johnson, Deputy Assistant Secretary for Single Family Housing, U.S. Department of Housing and Urban Development, to the president of Dependable Mortgage, Inc. (August 9, 1996).

to originate FHA mortgages within 60 days. (According to HUD staff, after HUD threatened to impose these sanctions, Dependable apparently voluntarily surrendered its Direct Endorsement authority in June 1997, sold its loan portfolio, and ceased operation.[67])

Interestingly, Deborah Tanke, who was president of Dependable at the time the Rollinses purchased their house, apparently personally notarized the false gift affidavit documenting the alleged gift from Lockhart. In her deposition, however, Tanke claimed to have no independent recollection of having done this, and could only surmise that she assisted in the Rollinses' closing because Dependable was shorthanded at the time.[68] After disbanding Dependable Mortgage, Tanke and another employee formed another loan company which was then outside the reach of a HUD debarment.

During the Subcommittee's hearings on mortgage flipping, Chairman Collins advised Senator Durbin that Tanke was still operating in the loan business in Chicago—a fact which Senator Collins found to be very disconcerting. FHA Administrator Apgar professed to be unaware of that development, as indicated by the following exchange:

> "Q: What about the lender?
> A: The lender disappeared.
> Q: Well, we [the Subcommittee] found them.
> A: What?"[69]

Senator Collins told him that the lenders involved in the Rollins episode "are still operating in the loan business in Chicago. So we will help you find them."[70]

A FHA credit analysis "worksheet" is used to examine an applicant's personal and financial status, monthly shelter expense, funds required for closing expenses, effective monthly income and debts and obligations. As noted above in connection with the Smith case, an applicant's prospective housing expenses should not exceed 29 percent of gross effective monthly income. An analysis of the Rollinses' mortgage application indicated that the prospective housing expenses equaled exactly 29 percent of their gross monthly income. According to Stekeena, however, the amount listed as their monthly income on this form was overstated: It had been falsely inflated by approximately $600 per month, which was described as "rental income."

Stekeena said she was unaware that this false income amount had been included on her loan application, which she did not read before signing because "it was just another form." Surely not by coincidence, the falsely-attributed additional "income" was precisely the amount required to make the Rollinses appear to meet the 29 percent threshold. Under FHA guidelines, in other words, they should not have received the loan: Without such false "rental income" paperwork to pave the way for a government-backed loan, ELR would not have been able to sell the Rollinses the house.

At the Subcommittee hearing, Senator Collins asked Ms. Rollins about this issue:

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[67] Subcommittee staff telephone interview with Janice Ligon, Office of Lender Approval and Recertification, U.S. Department of Housing and Urban Development (May 7, 2000).
[68] Deposition of Deborah Tanke, at 120:1–5 (March 8, 2000).
[69] Hearing record, *supra*, at 57.
[70] *Id.*

"Q: Did you, in fact, receive $618 in rental income every month?
A: No.
Q: Did you put that number on the form?
A: No.
Q: Did you tell anyone to put that number on that form?
A: No.
Q: And you weren't even aware that that number had been put on the form to make it appear that you qualified for the mortgage?
A: No." [71]

After the Rollinses had signed all the papers at the closing, Sandow told them that "house sitters" were staying at the house and instructed the Rollinses to go to the house, ask these persons for the keys, and request that they leave.[72] When the Rollinses arrived there, they observed drug paraphernalia scattered around the house. The alleged "house sitters" also refused to leave, and a 2-hour argument ensued. In the end, these persons agreed to leave when Shirley's son arrived at the house. The "house sitters" were apparently drug dealers: To this day, almost 5 years later, strangers still periodically visit the Rollinses' house seeking to purchase drugs there.[73]

The Rollinses had visited the house three times before closing, but ELR representatives had never allowed them to see the entire house due to what they characterized as "ongoing construction". When the Rollinses arrived at the house after closing, the reason for this refusal became clear: They observed termites swarming everywhere—on the front and back porches, inside the house, and in the garage. A subsequent telephone call to the company that conducted the termite inspection proved fruitless; a representative of that company simply advised them that ELR often painted over possible termite infestation, thereby preventing its detection by a normal inspection. This termite damage was so severe, in fact, that Stekeena fell on the front porch and severely hurt her leg.[74]

The Rollinses also soon began discovering other problems with the house. Contrary to Sandow's representations, the house was not suitable for a day care center because it did not meet city standards. Stekeena's business application was accordingly denied.[75] (A substandard furnace in the basement caused leaks.[76] A gas company representative told them that the pipes used on the furnaces were old, were not originally designed to be gas pipes, and appeared to be connected in a slipshod fashion.[77]) A gap also developed between the wall and the floor in the living room, actually creating an opening to the outside through which snow and rodents entered the house. Other problems with the house included water

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[71] Hearing record, *supra*, at 28.
[72] *Id.*
[73] Subcommittee staff interview with Stekeena and Shirley Rollins in Chicago, Illinois (March 28, 2000).
[74] Deposition of Stekeena Rollins, at 35:3–6 (December 8, 1999).
[75] Subcommittee staff interview with Stekeena and Shirley Rollins in Chicago, Illinois (March 28, 2000).
[76] *Id.*
[77] In December 1997, the Chicago Community Economic Development Association repaired and retrofitted the Rollinses' furnace pilot light system, insulated the attic, installed a smoke detector, and repaired doors. These efforts cost the Rollinses almost $2,500.

leaks, sewage backups in bathrooms, and faulty electrical wiring.[78] An attorney who is attempting to renegotiate the Rollinses' mortgage also told them that the house had been illegally converted into a two-flat structure.[79]

The Rollinses complained numerous times to ELR about the condition of their house. In response to their first complaints, ELR sent workmen to the house on approximately five occasions. These workmen repaired water damage to the first floor bedroom and dining room ceilings, and damage that had resulted from pipes freezing due to lack of insulation. They also painted the front porch to cover boards that had been damaged by rot, replaced the first- and second-floor carpets that had suffered water damage, and stabilized the collapsing back stairway.[80] Eventually, however, ELR stopped responding to the Rollinses' continuing complaints.

After the Rollinses finally contacted the FBI about ELR in January 1996, ELR resumed contact. Indeed, Sandow contacted them in April, offering them season tickets to the Chicago Bulls games and informing them that he would treat them to dinner if they stopped complaining. The Rollinses rejected these offers. Louis Prus, one of the owners of ELR, then stopped by to look at the house with his wife, but nothing resulted from his visit.[81]

By October 1999, the Rollinses were 2 or 3 months behind in their mortgage payments, but they have not made payments since June 2000 on account of a HUD moratorium on foreclosures of properties sold by ELR, and because of efforts by their attorney to renegotiate the terms of their mortgage.[82]

Investigation by Subcommittee staff has revealed that a non-profit organization called Pride Allied Educational Program had purchased the Rollinses' house from HUD for $11,430 in April 1995. Richard Nelson, co-owner of ELR, purchased the house from Pride Allied for $14,000 on May 5, 1995. Nelson sold the house 5 months later to the Rollinses for $119,000. Thus, although the owners of ELR have produced checks purporting to show approximately $52,000 in repairs made to the house prior to the Rollinses' closing, it is unlikely that even this dollar volume of repairs increased the house's market value in such a short period of time. Because ELR's records do not delineate in detail the types of repairs conducted on the house, moreover, it is unclear whether or not any repairs were actually made.

(2) *Other Easy Life Realty Victims*

The stories of the remaining ELR victims are remarkably similar in that they all made nominal down payments which ELR representatives supplemented with significant cash payments. ELR steered each victim to a lender of its choice, and, with one exception, provided the victim with an attorney to represent him or her at closing. In addition, each victim experienced major problems with the structural soundness and satisfactions of his home, which ELR failed to rectify.

[78] Subcommittee staff interview with Stekeena and Shirley Rollins in Chicago, Illinois (March 28, 2000).
[79] Subcommittee staff telephone interview with Stekeena Rollins (May 1, 2000).
[80] *Id.*
[81] Deposition of Stekeena Rollins, at 128:12–17 (December 8, 1999).
[82] Subcommittee staff telephone interview with Stekeena Rollins (May 1, 2000).

C. *South Florida: The Story of Sonia and Carlos Pratts*

Sonia Pratts and her husband Carlos purchased their home at 6121 Jackson Street in Hollywood, Florida, from New Southwest Properties, Inc. (NSP) for $80,000 on February 20, 1998. NSP had purchased the property on September 2, 1997 from HUD for only $40,000.

Sonia received an associate's degree in liberal arts from Boricua College in Brooklyn, New York. She has also taken pharmacy courses through ICS International Correspondence School, phlebotomy courses at Broward Community College, and counseling courses at Florida Bible College. Sonia formerly worked as a "ward clerk" and "certified nurse." In this capacity, she cared for premature, HIV-positive, and drug-addicted infants by performing such tasks as maintaining a sterile environment, monitoring medication and supplies inventory, bathing and weighing the infants, and preparing discharge and transfer paperwork. As a result of a back injury she suffered during the course of her employment, however, Sonia now works as a patient care assistant at a health care system surgical department, performing such tasks as drawing blood, transporting patients between departments, and bathing, dressing, and feeding patients. Her gross monthly income at the time she and Carlos purchased the house was roughly $1,200.

Carlos has a sixth-grade education. He was working as a driver/warehouse worker at Little Guys Food Service at the time he applied for their mortgage. (Sonia was eliminated from their loan application for the house because she had filed for bankruptcy nearly 10 years earlier after her ex-husband abandoned her and their three children.) In addition to his gross monthly salary of approximately $1,700, he was receiving Supplemental Security Income of $521 per month because he had been diagnosed as schizophrenic. He is presently unemployed.[83]

The Prattses had been saving to purchase a residence for several years. In October 1997, as they were driving through various neighborhoods looking at houses, they saw a sign posted in front of a house offered for sale by ERA Homeland Realty Corporation. The Prattses called the number on the sign and subsequently met with two realtors, P. Alias Thomas and ViJayan V. Thomas. The Thomases steered the Prattses away from the house that had initially attracted their attention to the house on Jackson Street that they ultimately purchased. The realtors then introduced the Prattses to Joe Kuruvila who, in addition to owning ERA Homeland Realty, also owned NSP which owned the Jackson Street property.[84]

The Prattses told Kuruvila that they wanted a property that needed no repairs because they were using their entire savings for the down payment, and would have no funds left over for renovations. When Kuruvila showed them the house on Jackson Street, the Prattses realized it was in the process being repaired. In response to their inquires, Kuruvila assured them that the property had no structural problems and no code violations. This was un-

[83] Subcommittee staff telephone interview with Sonia Pratts (June 16, 2000).
[84] Subcommittee staff interview with Carlos and Sonia Pratts in Hollywood, Florida (April 16, 2000).

true. At one point, Carlos drove by the house and noticed a code violation taped to the door.[85] City of Hollywood records confirm that a notice of code violations was posted on the Jackson Street property in October 1997. These code violations consisted of failing to obtain the requisite building permits for an addition to the property and for replacement of a window. (The city mailed NSP a letter via certified mail, return receipt requested, in November 1997, notifying it of the violations. The city again posted a noticed of the violations on the property in January 1998.) When Carlos confronted Kuruvila about the code violations, Kuruvila reassured him that all the necessary repairs would be completed, and that the code violations would be remedied.[86]

On December 20, 1997, the Prattses signed a contract for the purchase of the Jackson Street residence. This contract included a rider that subsequently became the subject of much controversy. This rider disclosed to the Prattses that NSP and ERA Homeland Realty were 100 percent shareholders of their mortgage lender, Hollywood Mortgage Corporation. In other words, Joe Kuruvila owned not only the Prattses' lender, but also the seller and the real estate agency. (A third entity listed on the rider as owning Hollywood Mortgage, Northeastern Properties, Inc., is also owned by Joe Kuruvila.) The Prattses told Subcommittee staff that when they signed the rider, they did not realize the relationship among the listed companies or the significance of Kuruvila's common ownership of them.[87]

The rider also provided that "[i]t is expressly understood that the property is sold 'as is', without any warranty to the purchaser, either express or implied" as to the property's zoning, its condition, freedom from defects, or fitness for any particular use or purposes. The Prattses contend that neither Kuruvila nor the Thomases explained this clause to them, and that they thus attached no particular significance to it when they signed the rider.[88]

Shortly after he signed the sales contract, Carlos signed a HUD form entitled, "Importance of Home Inspection." This form advised that FHA does not warrant the value or condition of a home, and encouraged the buyer to obtain an independent home inspection. Carlos indicated on the form that he chose not to have a home inspection performed. As with the "as is" clause, the Prattses attached no substantive significance to their waiver of a home inspection, particularly in light of Kuruvila's repeated assurances regarding the rehabilitation work that he was performing on the house.[89]

At their closing on February 20, 1998, the Prattses received virtually no explanation regarding the documents that they were being given to sign. They simply signed everything put in front of them because they trusted Kuruvila. They used their personal savings in order to provide the $3,900 they paid as a down payment and in order to cover closing costs; this was money they had been accumulating over a 2- or 3-year period.

[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] Subcommittee staff telephone interview with Sonia Pratts (April 24, 2000).
[89] *Id.*

The Prattses financed the balance of the purchase price through a 30-year mortgage in the principal amount of $79,959. Carlos executed an "escrow buy down agreement" which provided that in exchange for payments of $962.70 each from NSP and Hollywood Mortgage, the Prattses' interest rate would be 5.75 percent for the first year of the mortgage term, with a corresponding payment of principal and interest of $572.84 per month. For the second year of the mortgage term, the interest rate would be 6.75 percent, with a corresponding payment principal and interest of $518.61 per month. For the remainder of the mortgage term, the interest rate would be 7.75 percent, with a corresponding payment of principal and interest of $572.84. (This paperwork, as well as a clause in their sales contract, notified the Prattses that they were obtaining a variable rate mortgage. Sonia admits that she knew that they were obtaining a variable rate mortgage, but she says she did not believe that the rates would increase.)

The annual taxes for the property at the time of the sale were listed at $1,187.00. The monthly payment of these taxes, plus monthly premiums for FHA mortgage insurance and fire insurance, increased the Prattses' total monthly payments for the first year of the mortgage to $669.20. After the first 2 years of their mortgage term, their total monthly payments were scheduled to rise to $796.00 per month, as indicated on a document Carlos signed entitled "Acknowledgment of Estimate of Total Monthly Mortgage Payment."

The FHA credit analysis worksheet is used to examine an applicant's personal and financial status, monthly shelter expense, funds required for closing expenses, effective monthly income, and monthly debts and obligations. As a general rule, the applicant's prospective housing expenses should not exceed 29 percent of their gross effective monthly income. An analysis of Carlos Pratts's gross monthly income of $2,254.00 per month divided by the initial monthly mortgage payment of $669.20 indicates that his housing expenses were approximately 29.68 percent of his gross monthly income—in excess of the threshold suggested by the FHA guidelines.

The Prattses have experienced serious problems with the house despite the fact that Kuruvila told them that it had been completely rehabilitated. The roof—which Kuruvila told them was new—is rotting, collapsing, and leaking in several places. As a result, the ceilings have begun to crack and fall. When Subcommittee staff visited the house, they noted apparent water damage to the ceilings in a bedroom and back room of the residence. The staff also verified that the house has suffered rodent infestation as well as significant termite damage. (The living room, in fact, has a hole in the ceiling through which Sonia claims rat feces enter the room.) The addition, the rear of the house has substantial water damage and is built on top of the septic tank, which is a violation of City of Hollywood Construction Code and Health Department rules. The roof fascia is rotted and has many gaps through with rats and birds have gained entrance. The wiring also does not appear to be adequate, and several outlets are nonfunctional. So far, the Prattses have spent over $2,500 of their own money for various repairs, and there is no end in sight: An independent engineer they hired to evaluate the house advised them that they would need to

spend between $40,000 and $50,000 to bring it into compliance with the city building code—and that they would have to raze part of the house altogether.[90]

After the Prattses moved into their home, they received a letter from the City of Hollywood informing them of the outstanding building code violations on the property. The violations occurred long before either Kuruvila or the Prattses owned the house but the Prattses, as current owners, were responsible for ensuring compliance.[91]

When the Prattses questioned Kuruvila about the outstanding fines for the code violations, he assured the Prattses that he would pay them, but to date he has failed to do so. The Prattses have filed a civil complaint in State court against Kuruvila in an attempt to resolve this matter. In addition, the Real Estate Division of Florida's Department of Business and Professional Regulation has filed an administrative complaint against Kuruvila in his status as a real estate broker—and against his companies, NSP and Homeland ERA Realty—alleging fraud in conveying this property to the Prattses.

An appraiser named Raymond G. Wood conducted the appraisal of the Prattses' house that Kuruvila submitted in order to obtain FHA endorsement of their mortgage. This appraisal estimates that the fair market value of the Prattses' house was $82,000 as of January 8, 1998, and indicates that "the subject property conforms to all applicable minimum HUD/VA standards." Wood's appraisal also declares that the house is in overall average condition and that it has some new windows, a new roof, and new ceilings, although central air conditioning and appliances needed to be installed. Many of these claims were clearly false at the time. Wood told Subcommittee staff that he did not remember the property in question but that he had done "hundreds" of appraisals for Kuruvila until last fall, when he stopped because Kuruvila was very slow to pay him.

(Nor were these apparent misrepresentations the only problem with Wood's appraisal of the Prattses' house. In addition, the "comparable" property that Wood used to establish the value of the Prattses house appears also to have been a property "flipped" by Joe Kuruvila. Kuruvila purchased this property, located at 6028 Fillmore Street in Hollywood, for $43,200 from HUD on August 15, 1997. He sold it approximately 3 months later on November 19, 1997, for $81,000 to a buyer who had obtained an FHA-insured mortgage. Coincidentally, Wood conducted the pre-closing appraisal on the Fillmore Street property, subsequently also using it as the property against which to assess the purported value of the Prattses' home.)

D. *Norfolk*

A flipping scheme run by Wendell Chick in Norfolk, Virginia, illustrates the extent to which smaller cities are also susceptible to flipping frauds—and how such activities can inflict great harm

[90] Subcommittee staff telephone interview with Jim Ward (April 18, 2000); interview with Carlos and Sonia Pratts, in Hollywood, Florida (April 16, 2000).

[91] Subcommittee staff telephone interview with Everett Lawson (June 19, 2000); interview with Carlos and Sonia Pratts, in Hollywood, Florida. (April 16, 2000).

upon entire neighborhoods. Wendell Chick was a real estate broker and principal in multiple companies he utilized to inflate the value of properties he had purchased, minimally rehabilitated, and then resold. (Chick is currently serving a 60-month prison sentence as a result of his 1997 guilty plea to Federal wire fraud and money laundering conspiracy charges that arose from this conduct.)[92]

Between May 1993 and April 1997, Chick owned or controlled corporations through which he purchased approximately 34 properties in relatively poor condition in Norfolk, Portsmouth, and Chesapeake, Virginia. The purchase price of these properties ranged from $9,000 to $69,900, with an average price of approximately $30,500. Chick and his associates executed and recorded deeds purporting to convey the properties from one Chick-controlled company to another. Each time the properties were "sold" to a new company Chick controlled, their prices were inflated incrementally in order to create the illusion of a steadily increasing market value. These property transfers were solely paper transactions; no money ever changed hands, and the properties never left Chick's control.

Once a property's value had been sufficiently inflated by these means, Chick and his associates recruited purchasers whom they helped obtain mortgage loans through fraudulent means. Typically, Chick and his cohorts made cash, loan, and credit card payments—generally totaling several thousand dollars—to or on behalf of each of these purchasers, who thereupon falsely attested on their sales contracts that they had paid "earnest money" deposits on the properties out of their own funds.

Chick caused his purchasers to submit 34 different fraudulent mortgage applications for loans totaling approximately $2,746,564. (Nineteen of these loans were FHA insured.) Chick and his associates used a number of means to obtain such loans: They submitted to the lenders copies of checks that falsely purported to be "earnest money" deposits made by the purchasers; they paid outstanding credit accounts on behalf of the purchasers; and they provided funds to the purchasers to deposit into bank accounts in order to inflate apparent balances—thus leading lenders to believe that the purchasers were more solvent than was in fact the case. (To explain the source of funds in the purchasers' accounts, Chick produced forged gift letters and prepared fictitious certificates of title to motor vehicles, as well as receipts documenting non-existent sales of those vehicles to third parties.) In addition, at the loan closings, Chick and his associates themselves made the cash payments required of the purchasers.

Apparently, Chick also misled lenders about HUD policy. In express contravention of HUD policy, for example, Chick told buyers that although they had to represent to the lenders that they intended to live in the houses they were buying, in actuality HUD "didn't care whether they lived there only 1 day." Most of the HUD settlement statements also listed false debts secured by the properties.

[92] *See United States v. Wendell Chick,* Case No. 2:97CR00124–001 (E.D. Va. Dec. 15, 1997) (judgment).

E. *Southern California*

While exploring such problems of mortgage fraud, Subcommittee staff attended a number of conferences devoted to assessing the impact of—and preventing—predatory lending practices.[93] Among other events, Subcommittee staff attended the monthly meeting of the Los Angeles Housing Task Force. This group, which includes representatives from HUD/OIG, the Los Angeles Police Department, the California State Bar, the Southern California Consumer Law Center, and the Los Angeles Sheriff's Department, was created to combat mortgage fraud in the State of California. The task force discussed how Los Angeles has been successfully targeting mortgage fraud through training and consumer awareness.

According to these experts, local and Federal law enforcement have traditionally been reluctant to prosecute flipping and other types of mortgage fraud cases because they are highly technical and difficult to prove. Many local district attorneys told Subcommittee staff that they required special training in order to acquire the level of understanding necessary to prosecute these cases (much as was the case with Medicare fraud cases in the late 1980's). In response to this need for training, Manuel Duran, a consultant for the Southern California Consumer Law Center, successfully lobbied for the passage of a bill through the State legislature that imposes a $2 surcharge on each property deed filed in the State. The funds this surcharge generates are used to train law enforcement to investigate and prosecute mortgage fraud cases. Duran and members of the task force reiterated their belief that the answer to combating mortgage fraud lies in training law enforcement to prosecute these highly specialized criminals. (These officials indicated that pre-purchase counseling for homeowners is not by itself an adequate response, inasmuch as it rarely provides an effective deterrent to mortgage criminals.)

According to Nicholas Aquino—a Supervising Investigator who heads the Real Estate Fraud Section of the Los Angeles County Department of Consumer Affairs, which is responsible for addressing real estate fraud complaints—southern California has been plagued by an increasing number of mortgage fraud cases that have been perpetrated through the use of stolen identities. Investigating and prosecuting flipping, particularly when victims' misappropriated identities are used for straw purchases, is complicated for law enforcement officials because the victims may not actually know that they have been victimized until long after the "flip" occurs. (Meanwhile, evidence becomes stale, and witnesses forget key details about the transactions at issue. This places special burdens upon prosecutors.)

Aquino sees flipping as being a "huge" problem in Los Angeles County. In one scheme that is currently under investigation, for example, perpetrators placed advertisements in local newspapers and canvassed neighborhoods offering low-income, first-time home buy-

[93] Among these conferences was a HUD forum in Los Angeles on May 3, 2000. This conference featured an address by a member of the Joint Task Force, case studies on predatory lending, participation by a variety of local and national industry representatives, and a consumer panel that included AARP, Bet Tzedek Legal Services, the Consumers Union, the Southern California Consumer Law Center, and Neighborhood Housing Services of Los Angeles. The focus of this event was the effect of predatory lending on elderly communities. During the conference, Subcommittee staff discussed the problem of flipping with various stakeholders.

ers the opportunity to purchase a house. The individuals who responded to the offer completed a mortgage application, only to be told that they did not qualify for a loan. The perpetrators then used the victims' identification data on the mortgage application to purchase houses themselves, using the victims' names. These properties were then resold at inflated prices.[94]

In December 1999, a Federal grand jury charged 39 persons with obtaining more than $110 million worth of fraudulent FHA insured loans through the execution of multiple fraudulent schemes through Allstate Mortgage Company.[95] Allstate set up straw companies to enter into purchase agreements to acquire apartment buildings, typically worth $100,000 to $180,000. It then hired its own appraisers who inflated the value of the buildings, usually from $100,000 to $150,000 greater than the actual market value of the properties. (Allstate also instructed appraisers to certify that properties contained four residential units even though many had more than four units. It knew that under HUD's single-family insurance program the Department insured only mortgages on properties with four or fewer units.) Allstate then recruited low-income individuals to serve as straw buyers and apply for FHA mortgages in amounts equal to as much as $150,000 above the actual property values in question. As the FHA-insured loans were being arranged, Allstate simultaneously closed on its original purchase of the properties for the actual price, pocketed the difference between its purchase price and the taxpayer-insured loan proceeds, and then sold the fraudulent loans to legitimate mortgage companies.[96]

The Federal grand jury charges stemmed from a concentrated probe by teams of HUD/OIG auditors, FBI agents, and IRS agents in Southern California. At a news conference announcing the indictment, HUD Inspector General Susan Gaffney suggested that these charges were only "the tip of the iceberg." The U.S. Attorney for the Central District of California noted that this type of fraud "takes money from needy parents who dream of providing a house for their children and puts it into the pockets of people who have been licensed as professionals, but who really are just greedy criminals."[97]

IV. *The Federal Housing Authority*

A. *Origin and Structure*

The Housing Act of 1934 established FHA in order to broaden home ownership, protect lending institutions, and stimulate the building industry. By insuring lenders against loss on home loans, FHA contributed to the institution of the 30-year mortgage as a standard mortgage product. When HUD was created in 1965, FHA became an agency of HUD. All FHA programs are administered

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[94] Subcommittee staff telephone interviews of Nicholas V. Aquino, Supervising Investigator, Real Estate Fraud Section, Los Angeles County Department of Consumer Affairs (February 2 and June 14, 2000).

[95] *See* David Rosenzweig, "Thirty-Nine Charged in Crackdown on Fraud in FHA-Backed Loans," *Los Angeles Times* (December 16, 1999), **http://www.latimes.com/news/state/199912/16t000114613.html.**

[96] Office of the Inspector General, U.S. Department of Housing and Urban Development, Audit Memo. # 00–SF–121–0802, *Internal Audit—Single Family Housing: Los Angeles Area Office and Santa Ana Home Ownership Center* (April 6, 2000), at 4.

[97] *See* Rosenzweig, *supra*.

through the HUD Office of Housing.[98] Since its inception in 1934, FHA has insured nearly 27.9 million loans.[99] FHA is organized into four major mortgage insurance fund activities. The largest activity is the Mutual Mortgage Insurance Fund (MMIF), which provides single family housing insurance.

The MMIF was designed to be actuarially sound and self-supporting. In fiscal year 1987, however, the fund barely broke even, and in 1988 the MMIF suffered its first net loss. In 1989, the MMIF's income remained insufficient to cover losses.[100] The MMIF had about $4 billion in reserves at the end of fiscal year 1987. Thanks to its slide into deficits, however, by the end of fiscal year 1991, the MMIF reserves had shrunk to $871 million.[101]

In 1991, as a result of these problems, Congress authorized HUD to increase FHA insurance premiums in order to keep the fund solvent. Prior to that time, on a 30-year mortgage, a borrower paid a one-time Mortgage Insurance Premium (MIP) of 3.8 percent of the amount borrowed. As of July 1, 1991, however, the borrower had to pay an additional annual premium of 0.5 percent in addition to the 3.8 percent one-time payment already required.[102]

In 1994, Congress enacted legislation to change the MIP calculations again in order to reflect the risk of the loans being insured.[103] For any loan insured on or after October 1, 1994, therefore, the borrower pays an up-front mortgage insurance premium of 2.25 percent of the loan amount. Thereafter, the borrower pays an annual insurance premium the amount and duration of which are determined by the size of the down payment: (a) a borrower who makes a down payment in excess of 10 percent will pay an annual insurance premium of 0.5 percent of the loan balance for the first 11 years of the loan; (b) a borrower who makes a down payment of 5 percent to 10 percent will pay an annual premium of 0.5 percent for the first 30 years of the loan; and (c) a borrower who makes a down payment of less than 5 percent will pay an annual premium of 0.55 percent of the loan balance for 30 years.[104]

B. *The Changing Face of FHA*

(1) *The 1980's: Coming to Grips With Mortgage Fraud*

Fraud involving FHA-backed mortgages for single-family residences, unfortunately, is nothing new. A 1986 HUD/OIG semiannual report, for example, described a case in which a house in Milwaukee was purchased for $13,950 and resold to an unqualified buyer for whom the seller had falsified a gift letter as evidence of a down payment to secure an FHA-backed mortgage. The buyer defaulted, the lender foreclosed on the house, and the FHA insurance fund suffered a loss of $43,100.[105] (This case looks very much like

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[98] U.S. Department of Housing and Urban Development, *About Housing* (visited June 19, 2000) **http://www.hud.gov/fha/fhaabout.html.**

[99] Foote, *supra*, at 1.

[100] Subcommittee staff telephone interview with Joe Rothchild, Office of Evaluation, Office of the Comptroller, U.S. Department of Housing and Urban Development (June 16, 2000).

[101] Foote, *supra,* at 4.

[102] Subcommittee staff telephone interview with Joe Rothchild, Office of Evaluation, Office of the Comptroller, U.S. Department of Housing and Urban Development (June 16, 2000).

[103] Foote, *supra,* at 4.

[104] *Id.*

[105] Office of the Inspector General, U.S. Department of Housing and Urban Development, *Semiannual Report to the Congress* (October 1, 1985-March 31, 1986) [hereinafter "HUD/OIG, *1985–86 Semiannual*"], at 6.

the mid/late-1990's case studies identified by the Subcommittee's investigation.) Another type of scheme that was prevalent in the 1980's involved "equity skimming." Equity skimming is the term used to describe frauds in which an investor who acquires a property, rents it to tenants, and then collects rent payments while not making the mortgage payments. The investor eventually allows the property to go into foreclosure, but only after he has collected enough rent to amortize his equity in the property.[106]

In response to such reports of widespread and growing abuse of the FHA mortgage program, HUD Secretary Samuel Pierce announced the formation of HUD's Single Family Task Force in fiscal year 1985. The mission of the Task Force was to conduct reviews of single family policy issues and analyze data from loans endorsed since 1980. On April 3, 1986, Secretary Pierce announced that the Task Force had issued a report recommending, among other things, that: (i) HUD should aggressively pursue sanctions against those who abuse HUD programs, including seeking deficiency judgments against defaulting mortgagors; (ii) HUD should publicize actions taken against mortgagors, mortgagees, and others who abuse HUD programs; and (iii) the Mortgagee Review Board should take a firmer stand against mortgagees who violate HUD programs.[107]

In addition to implementing the Task Force recommendations, the HUD Office of Housing issued internal directives requiring closer monitoring of early defaults on FHA-backed mortgages and lender claims as a means of detecting fraudulent schemes.[108] The Office of Housing duly stepped up its enforcement efforts in order to focus quickly upon imprudent lenders and other parties, and to impose stringent monetary and administrative sanctions. That office also agreed to make instrumental programmatic changes to curb fraud, such as requiring detailed reviews of mortgage applications for previously owned HUD properties and eliminating a property owner's ability to refinance his mortgage by taking all the cash equity out of a property.[109]

(2) *Problems With the "Reinvention" of HUD Under the Clinton Administration*

A number of developments have occurred since 1992 that gravely damaged the monitoring and oversight systems HUD had implemented in order to protect its Single Family Insured Programs against fraud and abuse. In February 1993—in the first flush of "Reinventing Government" enthusiasms promoted by Vice President Gore—HUD Secretary Henry Cisneros initiated a "reinvention" effort to make HUD more efficient and, apparently more importantly, to show Congress that HUD should not simply be dismantled.

[106] Office of the Inspector General, U.S. Department of Housing and Urban Development, *Semiannual Report to the Congress* (April 1986-September 1986), at 5.
[107] HUD/OIG, *1985–86 Semiannual, supra,* at 7.
[108] The Office of Housing is the office within HUD—under the direction of the Under Secretary for Housing/Federal Housing Commissioner—that carries out FHA programs.
[109] *1985–86 Semianual, supra,* at 8.

(a) *Liberalization of Controls Over Direct Endorsement Lenders*

In 1995, FHA issued Mortgagee Letter 95–7, which significantly liberalized Direct Endorsement lender underwriting requirements.[110] HUD claimed that these changes would eliminate unnecessary barriers to home ownership, provide the flexibility to underwrite creditworthy nontraditional and underserved borrowers, and clarify certain underwriting requirements so that they are not applied in a discriminatory manner.[111] Significant changes implemented by this letter included the following:

- *Elimination of 5-year test for income stability:* Previously, only those sources of income reasonably expected to last for at least 5 years could be included in determining the borrower's income for qualifying purposes. The letter reduced this standard to an income expectation of 3 years.[112]
- *Recognizing income from overtime and bonuses:* Previously, bonuses and overtime over a 2-year period (received or expected) could be counted as income. After the promulgation of Mortgagee Letter 95–7, periods of less than 2 years could be considered for income calculations.[113]
- *Recognition of part-time income:* Jobs consisting of less than a 40-hour work week can now be considered for income calculations. (The lender must determine, however, that the continuance of this income is likely.)[114]
- *Elimination of child care as recurring debt:* Child care is no longer considered in the computation of debt-to-income ratios because, according to HUD, most families assessing their financial priorities will find alternate means of caring for their young children if such costs become burdensome.[115]
- *Use of automated underwriting systems and use of artificial intelligence in underwriting:* HUD approved lenders were also given permission to use automated underwriting systems for approving FHA-insured mortgages as long as the criteria were met for loan approval. (Artificial intelligence systems may be used for loan approvals only, and loans rejected by an artificial intelligence system must be reviewed by a human underwriter.) A DE underwriter must still execute the normal documents required on FHA-insured mortgages.[116]
- *DE approval for branch offices:* Once a lender obtains unconditional DE status for any one of its offices, addi-

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[110] HUD/OIG, *Single Family Production Home Ownership Centers, supra,* at 1.
[111] U.S. Department of Housing and Urban Development, *Mortgagee Letter 95–7* (January 27, 1995), at 1–6.
[112] *Id.* at 1.
[113] *Id.* at 1–2.
[114] *Id.* at 2.
[115] *Id.* at 2.
[116] *Id.* at 4.

tional branch offices that become approved to do business with HUD are now automatically granted DE approval.[117]

- *Alternative documentation—revised instructions:* If a former employer is no longer in business at the time of the underwriting, and if a verification of past employment cannot thus be made, the underwriter need only verify by telephone all current employment. Also, the requirement that the lender obtain bank statements covering the most recent 3-month period for bank statement transactions can now be met merely by obtaining the two most recent two bank statements. (The lender may also utilize an electronic retrieval service for W–2 and tax return information, although it cannot charge the borrower for this service.)[118]

(b) *HUD 2020 Management Reform Plan*

The HUD "reinvention" effort expanded further—with rather problematic results—under Secretary Andrew Cuomo. On June 26, 1997, Secretary Cuomo announced a new management reform plan for HUD.[119] The plan—dubbed "HUD 2020"—aimed to transform HUD from what Cuomo called "the poster child for inept government that has been plagued for years by scandal and mismanagement" into "a new HUD, a HUD that works."[120] The 2020 Management Reform Plan included several specific steps: The creation of a new Enforcement Division to fight waste, fraud, and abuse; the consolidation of over 300 HUD programs and activities into 71; the establishment of a new financial information management system; and the reduction of the size of HUD's staff from 10,500 to 7,500 by the end of the year 2000. In addition, the 2020 Management Reform Plan called for the consolidation of all single-family operations from 81 locations across the country into three Home Ownership Centers (HOCs). (The number of HOCs was later increased to four; they are presently located in Philadelphia, Pennsylvania, in Atlanta, Georgia, in Denver, Colorado, and in Santa Ana, California.)

The Real Estate Assessment Center (REAC) is responsible for assessing the overall physical and financial condition of HUD's vast housing portfolio, theoretically enabling HUD better to target its monitoring and enforcement resources. Because other HUD organizations are so dependent upon its work, REAC was the linchpin of HUD's 2020 Management Reform Plan.

REAC's functions regarding HUD's Single Family Insured Programs, however, are largely limited to appraiser oversight. REAC's Single Family Appraisal Quality Assessment Team (QAT) conducts reviews of appraisals for FHA-insured single family homes. The reviews assess the accuracy and completeness of FHA appraisal reports in order to reduce the probability of costly and unexpected repairs to home buyers. (Inadequate appraisals make it that much

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[117] *Id.* at 5.
[118] *Id.*
[119] U.S. Department of Housing and Urban Development, press release, "Cuomo Announces Historic Management Reforms For HUD To Stamp Out Waste, Fraud and Abuse and Improve Performance" (June 26, 1997), **http://www.hud.gov/pressrel/pr97-109.html,** at 1.
[120] *Id.*

harder for home buyers to become aware of extensive repairs that may be required to make their homes habitable. If they purchase housing in ignorance of such defects, they may be unable to afford the costs these problems impose, and are thus much more likely subsequently to default on their FHA-insured mortgages.) In addition, the QAT created a standard for appraisal knowledge by requiring appraisers to pass the FHA appraiser examination in order to be eligible to perform FHA appraisals. These activities support the reforms initiated in the Homebuyer Protection Plan, which "reinvented" FHA's appraisal process.[121]

(c) *Soaring Defaults and Foreclosures*

Between fiscal years 1997 and 1999, the number of single family mortgage loans that FHA insured grew from approximately 800,000 to nearly 1.3 million—a 63 percent increase. (For these 3 years combined, FHA insured over 3 million mortgages with a total value of $292 billion.)[122] This dramatic increase in endorsements, however, has been accompanied by a similar increase in delinquency and foreclosure rates. In fact, as the HUD/OIG reported in 2000, there has been

> "an increase of over 50 percent in FHA loan foreclosure rates over the last 5 years from 1.45 percent in 1994 to 2.20 percent through three quarters of 1999. Similarly, Mortgage Banker Association data shows an increase of over 18 percent in FHA delinquency rates (from 7.26 percent to 8.57 percent) during the same period."[123]

The Mortgage Bankers Association National Delinquency Survey report for the fourth quarter of 1999 explains further that,

> "[t]he inventory of loans in foreclosure at the end of the quarter declined for conventional loans, but rose for FHA and VA loans. The percentage of FHA loans in foreclosure increased 3 basis points to 2.01 percent."[124]

Thus, although FHA points to the aggregate increase in American home ownership as a measure of success, the associated rise in defaults and foreclosures HUD has permitted through lax oversight suggests that FHA is subjecting the MMIF to greater risks by endorsing mortgages made to unqualified borrowers. Findings by both the U.S. General Accounting Office and HUD's/OIG support this conclusion.

(d) *HUD's Response*

In response to these criticisms, then-Secretary Cuomo simply denied the accuracy of the figures produced by MBA, and quoted by the OIG, that indicate this steady rise in FHA defaults and foreclosures. Implicitly acknowledging the criticism, however, HUD has announced a series of programs designed to curb fraud and waste in the Single Family Insured Program, as follows:

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[121] U.S. Department of Housing and Urban Development, *Single Family Appraisal Quality Assessment* (visited June 19, 2000), **http://www.hud.gov/reac/products/prodsfa/cfm,** at 1.

[122] U.S. General Accounting Office, *Oversight of FHA Lenders: Single Family Housing,* GAO/RCED–00–112 (April 28, 2000), at 6.

[123] HUD/OIG, *Single Family Production Home Ownership Centers, supra,* at *iii.*

[124] Mortgage Bankers Association, National Delinquency Survey for the 4th Quarter of 1999 (last modified March 29, 2000), **http://www.mbaa.org/marketdata/nds/0499.html,** at 1.

(i) *Loss Mitigation Program*

Until April 1996, FHA-insured homeowners who encountered financial difficulties had the benefit of the FHA Assignment Program, which was designed to provide temporary relief for mortgagors who experience financial difficulties resulting in mortgage default. The relief offered by this program was in the form of a mortgage assignment to HUD with a forbearance plan that offered reduced or suspended payments for a period of up to 36 months.

The Assignment Program was terminated in April 1996 by the Balanced Budget Downpayment Act. Its replacement, FHA's Loss Mitigation Program, is designed to reduce the number of foreclosures and the costs associated with foreclosures. Under this program, lenders are compensated for using one of five loss mitigation tools to help borrowers in default avoid foreclosure:

- *Special forbearance:* This allows a period of reduced (or even suspended) payments for the borrower, and is designed to provide relief to borrowers with temporary financial problems.
- *Mortgage Modification:* This results in the lowering of the interest rate, or the extension of the term of the mortgage, so as to reduce monthly payments to affordable levels for the mortgagor. Mortgage modifications are designed for borrowers who have recovered from financial distress, but whose net income has permanently dropped from its level prior to default.
- *Partial claim:* This provides what is essentially a second loan on the property. In such cases, FHA pays the amount necessary to cure the default, and a promissory note is issued to secure repayment of the partial claim. The second loan is interest free, and need not be paid until the first mortgage matures, is prepaid, or the borrower vacates the property.
- *Preforeclosure sale:* In these cases, a borrower's home is sold prior to foreclosure and the borrower is relieved of his mortgage obligation. The borrower's debt is forgiven.
- *Deed-in-lieu of foreclosure:* This provides for voluntary transfer of the deed to the lender; used primarily when pre-foreclosure sale fails.[125]

As part of the HUD 2020 Management Reform, the National Servicing and Loss Mitigation Center became fully operational in Oklahoma City in February 1998. This Center consolidated HUD's loss mitigation function into a single centralized office and created a single point of contact for lenders and borrowers.[126]

Unfortunately, HUD had difficulty in ensuring proper oversight even over the programs it developed in order to mitigate the foreclosure problems caused by its failure properly to oversee its FHA-backed single-family loan program. A September 1999 HUD Office

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[125] Office of the Inspector General, U.S. Department of Housing and Urban Development, Audit Report # 99–DE–121–0001, *Department of Housing and Urban Development's Loss Mitigation Program* (September 30, 1999) [hereinafter "HUD/OIG *Loss Mitigation Program"*], at 1.

[126] Office of the Inspector General, U.S. Department of Housing and Urban Development, *Semiannual Report to the Congress* (April 1, 1999-September 30, 1999), at 10.

of the Inspector General (HUD/OIG) report, for example, found that the utilization of home retention and loss mitigation tools had increased dramatically in the preceding year. The report, however, also found a lack of program oversight and weaknesses in the monitoring of mortgagees.[127] Specifically, the report found that HUD needed to improve its review of loss mitigation claims, and its monitoring and oversight of lenders' use of loss mitigation tools. Furthermore, the HUD/OIG also raised concerns that HUD's ability to effectively monitor the FHA loan portfolio is compromised because of inaccurate and incomplete information contained within its Single Family Default Monitoring System (SFDMS).[128] Unreliable default status information, which it transmitted by servicing mortgagees to HUD, clearly makes it difficult to assess the potential risk and cost to the FHA insurance fund.

(ii) *Credit Watch*

Credit Watch is a computer system HUD implemented in May 1999 to evaluate the performance of lenders and track loans they have made so that, even when a loan is sold to another lender and later goes into default, the originating lender for that loan will be credited with the default.[129] Credit Watch is designed to enable HUD to terminate the loan origination authority of lenders with excessive defaults and insurance claims on FHA-insured mortgages. Pursuant to the program, HUD may terminate the loan origination authority of any lender whose default and claim rates on FHA-insured mortgages during the preceding 24 months exceeds both the national average and 300 percent of the average rate for the HOC serving the lender's geographic location. (Similarly, HUD may place on "credit watch" the lenders whose default and claim rates exceeds both the national average and 200 percent of the corresponding HUD field office average.) While on credit watch, a lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD. Because the program regulations pertain only to lenders that originated the troubled loans, however, HUD does not always hold accountable the DE lenders that underwrote and approved the loans.

The first round of Credit Watch terminations occurred on September 15, 1999, when HUD ended its relationship with 26 FHA lenders because they had default/claim rates that exceeded the national rate and 300 percent of the HOC rate. Another 100 lenders were placed on the Credit Watch list for monitoring. One of the 26 FHA lenders, Capitol Mortgage Banks, Inc., however, successfully challenged HUD's authority to take this action in Federal court in Baltimore.[130] Specifically, the court found that FHA exceeded its authority in terminating that lender, and declared the Credit Watch basis for termination was unlawful and invalid. The court

[127] HUD/OIG, *Loss Mitigation Program, supra,* at *i.*

[128] Servicing lenders must report to HUD monthly on the current status of all loans that are in default for 90 days or more. The SFDMS is the only database that stores and maintains default status codes. HUD's only other means of obtaining default status data is from the Government National Mortgage Association default data, which is compiled on a quarterly basis, or by calling the lender directly to determine the status of individual FHA loans. *See generally* HUD/OIG, *Loss Mitigation Program, supra,* at 23–24.

[129] William Apgar, Federal Housing Commissioner, U.S. Department of Housing and Urban Development, remarks at HUD/OIG Manager's Conference (June 7, 2000).

[130] *See Capitol Mortgage Banker, Inc. v. Cuomo,* 77 F.Supp. 690 (D.Md. 1999).

also ruled that HUD must in the future give lenders an opportunity to take corrective action before termination occurs. For these reasons, the court ordered the reinstatement of Capitol Mortgage Bankers as an FHA-approved lender.

The decision was appealed by HUD, and in September 2000, the Fourth Circuit Court of Appeals in Richmond, Virginia ruled that HUD had acted appropriately and overturned the District Court decision. In July 2001, the Senate Appropriations Committee included language in the fiscal year 2002 Veterans Affairs-HUD Appropriations Bill, S. 1216, that would allow HUD to review early defaults and claims, and if appropriate, result in the automatic suspension or termination of poor performing mortgagees.

(iii) *The Homebuyer Protection Plan*

In June 1998, HUD announced a new Homebuyer Protection Plan "to improve home appraisals for over 1 million families who purchase homes each year with HUD-insured mortgages." [131] HUD described this plan as featuring six key components:

- *A new consumer education campaign about appraisals and inspections conducted by HUD, the National Association of Realtors, and the Mortgage Bankers Association of America.* [132]
- *Mandatory testing of all appraisers to determine whether they are qualified to perform FHA appraisals.* Approximately 30,000 private appraisers around the Nation, who perform mandatory appraisals before the sale of every home financed with an FHA mortgage, will be tested. Appraisers failing this test will not be certified to perform FHA appraisals until they pass the exam, which is intended to help ensure that appraisers know and understand FHA requirements.[133]
- *More thorough and reliable appraisals designed to uncover significant defects in homes.* [134] HUD sought to accomplish this change through revision of its comprehensive valuation package (CVP), which consists of three parts. Its first part is the Uniform Residential Appraisal Report (URAR), which was not modified. The second part is the "Valuation Conditions—Notice to the Lender" form ("VC sheet"), which the appraiser is required to complete to reflect readily observable information relevant in determining the property's "as-repaired" value. HUD revised the VC sheet to reflect more specific conditions relevant to determining whether the property meets HUD's Minimum Property Standards or Requirements (MPS/MPR), but HUD nevertheless maintains that the requirements of the new VC sheet are not materially different from the previous version of the VC

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[131] U.S. Department of Housing and Urban Development, press release, "Cuomo Announces New Initiative to Protect Consumers from Buying HUD-Insured Homes with Undetected Defects" (June 10, 1999) [hereinafter "June 10, 1999 press release"] **http://www.hud.gov/pressrel/pr99–99.html.** at 1

[132] June 10, 1999 press release, *supra,* at 1.

[133] *Id.*

[134] *Id.*

sheet.[135] The third and final part is the Homebuyer Summary, which the appraiser must prepare if he notes any MPS/MPR nonconformity on the property.

- *Mandatory disclosure of detected home defects to home buyers through the Homebuyer Summary.*[136] The appraiser must sign the Homebuyer Summary and provide it as part of the CVP to the lender. The lender is then responsible for providing each prospective borrower with the Homebuyer Summary when the appraiser has noted a nonconformity on the property. The lender's Direct Endorsement underwriter must review the Homebuyer Summary to assure that it is complete. Borrowers must receive the Homebuyer Summary at least 5 days prior to the loan closing, and must sign and date it to acknowledge their receipt. (The lender must also include a copy of the summary in the case binder it submits to FHA for insurance endorsement.) Repair items must be completed prior to the loan closing.[137]
- *Automated evaluation of appraisals.* HUD will establish a system that enables it to collect appraisal data electronically and to track trends in appraisal quality. The new system is designed to enable HUD to perform high-speed computer-generated reviews of the performance of all appraisers, so that appraisers found to make inaccurate appraisals can be spotted and targeted for further review and possible enforcement action. HUD has developed a series of statistical indicators to help target its appraiser oversight activities, particularly its field review activities. These indicators work by comparing home values derived by appraisers and the techniques used to establish the values. Individual indicators are then combined into a single appraisal score using a statistically-derived weighting system.[138]
- *Stricter enforcement action to suspend poorly performing appraisers from working for FHA.*[139]

Although at the time of its announcement, HUD planned to phase in all aspects of the Homebuyer Protection Plan "over the next few weeks[,]" [140] HUD ultimately delayed until March 1, 2000 implementation of the regulatory changes relating to its enforcement actions against appraisers who perform appraisals that are not in compliance with FHA requirements.[141]

[135] Office of the Assistant Secretary for Housing-Federal Housing Commissioner, U.S. Department of Housing and Urban Development, *Mortgagee Letter 99–32* (November 12, 1999) [hereinafter *"Mortgagee Letter 99–32"*], **http://www.hudclips.org/sub—nonhud...MLET&u=./hudclips.cgi&p=1&r=28&f=G,** at 1.

[136] June 10, 1999 press release, *supra,* at 1.

[137] Office of the Assistant Secretary for Housing-Federal Housing Commissioner, U.S. Department of Housing and Urban Development, *Mortgagee Letter 99–18* (June 28, 1999) [hereinafter *"Mortgagee Letter 99–18"*], **http://www.hudclips.org/sub—nonhud...MLET&u=./hudclips.cgi&p=1&r=43&f=G,** at 2.

[138] June 10, 1999 press release, *supra,* at 1.

[139] *Id.*

[140] *Id.*

[141] *Mortgagee Letter 99–32, supra,* at 2

In addition, under HUD's plan, home buyers are now required to sign and date a new informational form entitled, "For Your Protection: Get a Home Inspection," before they purchase a home with an FHA mortgage.[142] (This form replaced the "Importance of Home Inspections" form that was previously required.) According to HUD, this new form "advises [home buyers] in plain English to get a home inspection in addition to an appraisal."[143] It informs buyers that FHA does not guarantee the value or condition of the property, that an appraisal is not a home inspection, and that the borrower has the right to have the house inspected by a professional home inspector. For all transactions involving FHA mortgage insurance on existing property, the home buyer must sign and date this form on or before the date that the sales contract is executed. The lender must also include a copy of the signed and dated form in the case binder it submits to FHA for insurance endorsement.[144]

(iv) *Fraud Protection Plan*

HUD's Fraud Protection Plan is an outgrowth of its Baltimore Task Force. Working with Senator Mikulski as a result of constituent complaints and reports that appeared in the *Baltimore Sun,* HUD launched the Baltimore Task Force in April 2000. Its purpose was to gather information on the cause and extent of mortgage frauds and resulting foreclosures, and to develop recommendations that would both benefit Baltimore and serve as a model for FHA programmatic reform throughout the Nation. FHA declared a 90-day moratorium on foreclosures of FHA-insured loans in Baltimore, which enabled HUD to send a so-called "SWAT Team" of departmental officials to Baltimore to identify fraud or predatory practices involved in FHA-backed loans before foreclosures and to help as many homeowners as possible avoid foreclosures. HUD staff intensively reviewed case files for the 350 FHA borrowers in Baltimore who had received a notice of intent to foreclose after January 1, 2000, and found evidence of fraud or predatory lending in 50 to 60 cases. To help defaulting Baltimore homeowners avoid foreclosure, FHA attempted to contact all borrowers facing impending foreclosures in order to better focus resources on loss mitigation assistance. In "Hot Zone" areas, which it defines as areas with high concentrations of FHA foreclosures, FHA undertook to establish teams of loss mitigation specialists to work with lenders and borrowers to ensure that every effort is made to help families remain in their homes. In addition, FHA contacted the corresponding lender for each borrower to ensure that the lenders were properly evaluating borrowers and offering appropriate foreclosure avoidance options.

At its public forum in Baltimore on May 19, 2000, HUD announced its Fraud Protection Plan, which seeks to apply the Baltimore Task Force's recommendations to the rest of the country. The Plan has two primary foci: (1) Providing relief to FHA borrowers who are already in default, especially those who have been victimized by abusive lending practices; and (2) strengthening FHA en-

[142] *Mortgagee Letter 99–18, supra,* at 2.
[143] June 10, 1999 press release, *supra,* at 1.
[144] *Mortgagee Letter 99–18, supra,* at 2–3.

dorsement and fraud detection procedures to prevent predatory practices from occurring in the first place.

To achieve its first goal of assisting FHA borrowers already in default, HUD proposed to issue vouchers for fund foreclosure avoidance counseling at HUD-approved locations. By expanding the availability and improving the quality of such counseling, HUD sought to help homeowners make better use of currently available loss mitigation tools, such as mortgage modification and partial loan forgiveness.

For FHA borrowers saddled with inflated mortgages that stem from inflated appraisals, HUD plans to direct mortgage lenders to write down their mortgages to a level consistent with fair market appraisals. In situations where the lender refuses to honor this demand, FHA intends to intervene, cancel the existing mortgage, and refinance the property with a mortgage at the fair market value. The FHA insurance fund would bear the cost of redeeming the mortgage at the fair market value, and it is estimated that the cost in Baltimore alone could reach $30 million. In addition, HUD will instruct lenders to issue a "credit repair" letter, which is designed to help ensure that the victim's credit record is not harmed simply because the victim fell prey to fraud and predatory lending practices. HUD also intends to send teams of loss mitigation specialists to "Hot Zones" with high default and foreclosure rates, in order to ensure that every effort is made to help families remain in their homes.

To achieve its second goal of stopping predatory practices from undermining FHA's ability to promote housing opportunity, FHA will implement an automated system to review the sales price history of properties prior to FHA insurance endorsement. This may be one of the Plan's most promising initiatives, insofar as such a system would reveal when a house purchased for a very low price is quickly resold for a much higher price. Through such tracking of the warning signs of a potential "flip," officials would be able to intervene much more rapidly to both protect victims and punish wrongdoers. In addition, FHA will form additional "SWAT Teams," modeled on the Baltimore effort, to target abusive appraisal practices in Hot Zones around the country. (FHA also intends to suspend abusive real estate brokers from future participation in FHA programs, although it has not provided any specific information regarding how it plans to accomplish these suspensions.) Additionally, FHA intends to study its data on housing sales with an eye to developing early warning indicators of foreclosure "Hot Zones."

Finally, FHA is launching a new Appraisal Watch system modeled after the Credit Watch system now targeted to lenders. The goal of Appraisal Watch is to identify appraisers with a record of faulty appraisals and abusive practices, terminate them from FHA programs, and, if appropriate, pursue legal action.

(v) *Mortgage Credit Scorecard Project*

The Mortgage Credit Scorecard Project is a new automated underwriting system that gives credit scores for lenders. To accomplish this, it establishes lender profiles to be used to evaluate loan information that has been entered into the automated underwriting system. At present, one third of all FHA loans are processed

through this system, and the number of mortgages processed through the system is expected to increase to 50 percent within the next year.[145] (According to HUD, this reform is still in the "drawing board" stage.[146])

V. *Agency Criticisms of HUD*

A. *General Accounting Office*

(1) *GAO on HUD's Lack of Lender Oversight*

Recent cases of mortgage fraud across the country have raised concerns about HUD's oversight of FHA-insured lenders. For example, in December 1999, HUD's Office of the Inspector General and the Department of Justice announced criminal charges against 39 California mortgage lenders, real estate professionals, and other persons they accused of obtaining more than $110 million in fraudulent FHA-insured loans. At the request of Senator Collins and Representative Rick Lazio (R–NY), GAO prepared a report entitled, "Single Family Housing: Stronger Oversight of FHA Lenders Could Reduce HUD's Insurance Risk."

GAO's report addressed the following questions: (1) How well does HUD ensure that lenders granted DE authority by FHA are qualified to receive such authority? (2) To what extent does HUD focus on high-risk lenders in monitoring the lenders participating in FHA's mortgage insurance programs? (3) To what extent is HUD holding lenders accountable for poor performance? To address these questions, GAO reviewed the activities of HUD headquarters and its four Home Ownership Centers located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California.

(a) *Approval of Lenders to Receive DE Authority*

HUD's process for granting FHA-approved lenders DE authority provides limited assurance that lenders receiving this authority are in fact qualified. According to HUD's guidance, FHA-approved lenders seeking DE authority must demonstrate "acceptable performance" in underwriting at least 15 mortgage loans, which undergo evaluations, known as preclosing reviews, by HUD's HOCs. The guidance does not, however, define what would constitute overall acceptable performance on the 15 loans.

In the absence of such a clear definition, the various HOCs have interpreted what constitutes acceptable performance differently, and their standards for approving lenders for DE authority have thus been inconsistent. In the 6 months prior to GAO's 1999 visits, for instance, the HOCs granted DE authority to a total of 36 lenders. While many of these lenders had demonstrated proficiency in underwriting mortgages, many others made multiple and serious underwriting errors. Overall, 12 of the 36 lenders had received 4 or more "poor" ratings from the HOCs for their last 15 preclosing reviews.

According to GAO, the vagueness and inconsistent application of HUD's approval standards constitutes a risk to the insurance pro-

[145] Federal Housing Administrator William Apgar, remarks at HUD/OIG Manager's Conference (June 7, 2000).

[146] Subcommittee staff telephone interview with Judy Heaney, Community Builder, U.S. Department of Housing and Urban Development, Chicago, Illinois (June 16, 2000).

gram. GAO recommended that HUD improve the process for granting lenders DE authority by developing specific standards for overall acceptable performance in pre-closing reviews and ensuring that the HOCs comply with these standards.

(b) *Monitoring of Lenders*

(i) *On-Site Lender Reviews*

Contrary to HUD's guidance, the HOCs' monitoring of lenders does not adequately focus on the lenders and loans that pose the greatest insurance risks to HUD. On-site evaluations of lenders' operations—known as lender reviews—are one of HUD's primary tools for assessing the quality of lenders' mortgage-lending practices. HUD's guidance states that 85 percent of the lender reviews should be targeted at high risk lenders, while 15 percent should be selected randomly. HUD's guidance also stresses the importance of using risk analysis to allocate a larger share of monitoring resources to program activities that pose the highest risk to HUD. GAO found that lender reviews by HUD have increased in recent years, as HUD has placed greater emphasis on performing on-site evaluations of lenders' operations.

Nevertheless, GAO found that the HOCs have often not bothered to review the lenders and loans that they themselves consider to present the highest risks. For example, although the Philadelphia HOC conducted reviews of 228 lenders during fiscal year 1999, it reviewed only 39 of the 131 high-risk lenders (about 30 percent) that it had designated as high priorities for review that year. HUD officials told GAO that the lack of experienced staff and limited travel funds impeded HUD's ability to visit and review the riskiest lenders—although the HOC apparently had no problem devoting staff and financial resources to reviewing 189 lower-risk lenders instead of increasing the proportion of high-risk ones it evaluated. GAO also noted that HUD placed too much emphasis upon meeting numeric goals (e.g., being able to claim a higher aggregate number of lenders reviewed) instead of actually targeting high-risk loans. GAO recommended that HUD more effectively monitor lenders' performance by developing procedures to identify and prioritize high-risk lenders for review and ensuring that the HOCs consistently apply these procedures.

(ii) *Post-Endorsement Technical Reviews*

Desk audits to evaluate the underwriting quality of individual loans already committed to FHA insurance by DE lenders—known as post-endorsement technical reviews—are another important lender oversight tool. The large majority of HUD's technical reviews are performed by firms under contract with the HOCs. Technical reviews that reveal deficiencies may result in HUD requiring the lenders to compensate it for financial losses, or in HUD simply suspending the lenders' DE authority.

Although all four HOCs met HUD's goal to perform technical reviews of no less than 10 percent of all loans insured in fiscal year 1999, they generally did not target these reviews either toward loans that exhibit high-risk characteristics, or toward loans that were made by high-risk lenders, such as those with known performance problems. The HOCs also did not comply with HUD guid-

ance specifying that all loans by newly approved DE lenders should be subject to technical reviews. As a result, according to GAO, underwriting practices that significantly increase HUD's insurance risk may be going undetected.

One reason for this failure to target risky loans and lenders is that HUD's computer system currently cannot automatically identify and select high-risk loans for review. HUD has advised GAO that it is developing a "mortgage scorecard" computer system which, it believes, will make identification of high-risk loans easier.

Another problem GAO found concerned HUD's oversight of the contractors that conduct the bulk of its technical reviews. Each such contract contains specific performance standards expressed as the maximum accepted percentage of reviews that can contain significant errors, or omissions. GAO found that three of the four HOCs were not tracking the contractors' work against these standards. Without this information, the HOCs were not in a position to provide the contractors with adequate performance feedback or, if necessary, to enforce the contracts' performance clauses.

GAO recommended that HUD develop procedures and enhance FHA's management information systems in order to identify and select for technical review loans and lenders within each HOC jurisdiction that pose a high insurance risk to HUD. GAO also recommended that HUD comply with guidance to perform technical reviews of all the FHA-insured loans that are made by lenders that possess newly granted DE authority. In addition, GAO recommended that HUD track the performance of contractors conducting technical reviews against performance standards in the contracts, and take appropriate actions against contractors whose performance is not acceptable.

(c) *Enforcement Actions Against Lenders*

To hold lenders accountable for program violations or poor performance, HUD may (1) suspend their DE authority, (2) terminate their loan origination authority through its Credit Watch program, or (3) take enforcement action through its Mortgagee Review Board. Despite the availability of these measures, GAO found that HUD has not taken sufficient steps to hold lenders accountable for poor performance and program violations.

(i) *Suspension of DE Authority*

Although HUD's guidance allows the HOCs to suspend the DE authority of lenders who fail to comply with FHA's underwriting requirements, the HOCs have made only limited use of this authority. In fiscal year 1999, for example, the Philadelphia HOC suspended the DE authority of eight lenders—but it was the only HOC to suspend any lenders. Furthermore, HUD's technical review ratings for fiscal year 1999 showed that lenders frequently failed to comply with FHA's requirements, suggesting that many other lenders may by candidates for suspension.

GAO also found that the HOCs had not developed consistent criteria for evaluating lenders' ratings for mortgage credit analysis and suspending lenders' DE authority. Nearly 20 percent of the loans subject to HUD technical reviews received "poor" ratings for mortgage credit analysis, meaning that the lenders were found to

have made mistakes in evaluating the borrowers' credit worthiness that significantly increased HUD's insurance risk. This proportion, however, apparently understates the problem. In its own assessment, GAO identified 206 lenders that received "poor" ratings for their mortgage credit decisions in more than 30 percent of the loans HUD reviewed in fiscal year 1999. On the basis of this sample, a HUD review of all of the lenders' fiscal year 1999 loans should have found that the percentage of poor ratings exceeded 30 percent.

Despite the high proportion of "poor" ratings, moreover, the HOCs took little action against the problem lenders. Of the 206 lenders identified by GAO as having received poor ratings, 131 had made 10 or more FHA-insured loans in fiscal year 1999. As of October 1, 1999, however, the HOCs had not suspended the DE authority of any of these 131 problem lenders. Accordingly, GAO recommended that HUD strengthen its enforcement efforts by clarifying and implementing guidelines for identifying lenders whose DE authority should be suspended.

(ii) *Credit Watch*

As noted previously, HUD implemented its Credit Watch program in May 1999 in order to terminate the loan origination authority of lenders with excessive defaults and insurance claims on FHA-insured mortgages. Specifically, HUD planned to terminate the loan origination authority of any lender whose default and claim rates on mortgages insured by FHA during the preceding 24 months exceeded both the national average and 300 percent of the average rate for the HOC serving the lender's geographic location. Similarly, HUD planned to place on "credit watch" status the lenders whose default and claim rates exceeded both the national average and 200 percent of the corresponding HUD field office average. While on credit watch status, a lender can continue to originate FHA-insured loans, but its performance receives greater scrutiny from HUD. (Because the program regulations pertain only to lenders that originated the troubled loans, however, HUD does not always hold accountable the DE lenders that underwrote and approved the loans.)

HUD officials recognize that DE lenders contributed to excessive defaults and insurance claims, but that the Credit Watch program did not extend to DE lenders. HUD officials have also indicated that HUD has considered regulatory changes in order to solve this problem. Among other issues, the lender challenging the program has contended that HUD has exceeded its statutory authority when it issued its Credit Watch regulations and that the manner in which HUD terminated the lender's authority deprived the lender of due process. In October 1999, a U.S. District Court ruled that the regulations were invalid and set aside HUD's termination decision. The decision was appealed by HUD, and in September 2000, the Fourth Circuit Court of Appeals in Richmond, Virginia ruled that HUD had acted appropriately and overturned the District Court decision.

In July 2001, the Senate Appropriations Committee included language in the fiscal year 2002 Veterans Affairs-HUD Appropriations Bill, S. 1216, that would allow HUD to review early defaults and

claims, and if appropriate, result in the automatic suspension or termination of poor performing mortgagees.

GAO recommended that, once the legal basis for the Credit Watch program is resolved, HUD revise these regulations to cover DE lenders that underwrite FHA-insured loans with excessive default and claim rates, as well as those lenders who originate such loans.

(iii) *Mortgagee Review Board*

HUD's Mortgagee Review Board can impose administrative actions against FHA lenders who commit program violations. Most of the Board's actions result in settlement agreements, which require lenders to indemnify improperly originated loans, pay fines, and/or take actions to prevent future lending violations.

GAO found, however, that the Mortgagee Review Board's process for sanctioning lenders is overly time consuming. Administrative actions against FHA lenders who commit program violations frequently take more than 1 year to impose. As a result, some of these lenders continue making FHA-insured loans for 1 year or more after FHA has identified them as violators before being held accountable for past violations. HUD does not maintain guidelines for the time it should take the Board to take enforcement actions against lenders.

(d) *Agency Comments*

HUD responded that, while it did not always agree with the GAO report's characterization of its practices and procedures for overseeing FHA lenders, it generally agreed with GAO's recommendations. Among HUD's specific objections, however, were the following:

- HUD took issue with GAO's statement that its selection of loans for post-endorsement technical review was not based on risk. HUD maintained that it performs technical reviews of all higher default-rate type loans.
- HUD disagreed with GAO's finding that it was not monitoring the performance of technical review contractors. (GAO responded that it had not, in fact, claimed that HUD did no monitoring.)
- HUD commented that GAO's discussion of technical lender reviews did not adequately recognize that its targeting guidance requires HOC staff to consider several factors in addition to lenders' default and claim rates.
- HUD disagreed with GAO's recommendation that it clarify and implement guidelines for identifying lenders whose DE authority should be suspended. HUD said that it has threatened suspension in several dozen cases in an attempt to improve lenders' performance. According to HUD, the threat of a suspension has proven to be a constructive and successful means of improving lenders' performance.
- Finally, HUD agreed with GAO's recommendation to revise its Credit Watch program to hold both loan under-

writers and loan originators accountable for excessive default and claim rates.

(2) *HUD's Lack of Appraiser Oversight*

The purpose of an FHA appraisal, which is required for each property the agency insures, is (1) to determine the property's eligibility for mortgage insurance on the basis of its condition and location, and (2) to estimate the value of the property for mortgage insurance purposes. In performing these tasks, the appraiser is required to identify any visible deficiencies impairing the safety, sanitation, structural soundness, and continued marketability of the property and to assess the property's compliance with FHA's other minimum property standards. According to HUD guidance, if an appraiser finds noncompliance with these standards, he should include in his appraisal report an appropriate and specific action to correct the deficiency.

On-site assessments of completed appraisals, known as *field reviews,* are HUD's principal tool for monitoring the performance of the appraisers on FHA's roster. In conducting a field review, a HUD official or contractor visits the appraised property to evaluate all aspects of the appraisal, including whether the value determination was reasonable and whether all needed repairs were identified. The field reviewer is required to document these findings on a standard HUD form and recommend a score using a scale from 1 to 5 to assess the quality of the appraisal (with 1 being unacceptable and 5 being excellent).

The four Home Ownership Centers are expected to play important roles in HUD's oversight of the FHA appraisal process. According to HUD, its Real Estate Assessment Center is responsible for analyzing and tracking appraisal quality and appraiser performance, and its Enforcement Center is responsible for sanctioning appraisers, mortgage brokers, and lenders who do not comply with HUD's requirements.

On June 1, 1999, HUD announced a Homebuyer Protection Plan that HUD intended to implement in order to improve the FHA appraisal process. Specifically, the plan: (1) requires that appraisals include a more thorough basic survey of the physical condition of homes; (2) requires lenders to inform potential home buyers of defects found during appraisals; (3) requires appraisers to recommend complete, detailed inspections of homes if the appraisers find significant problems with the properties; (4) allows up to $300 of home inspection costs to be financed through FHA mortgages; and (5) imposes stricter accountability on appraisers and tougher sanctions on those who act improperly, including fines and potential prison sentences. HUD's announcement did not identify a specific timetable for implementing the plan.

Pursuant to a congressional request, GAO reviewed FHA's appraisal process, focusing on (a) how HUD ensures that appraisers on its roster are qualified to perform FHA appraisals; (b) how well HUD is monitoring the performance of the appraisers on its roster and implementing procedures for addressing consumers'complaints about FHA appraisals; (c) the extent to which HUD is holding appraisers accountable for poor-quality FHA appraisals; and (d) the extent to which HUD is holding lenders responsible for the quality

of the FHA appraisals they use. On April 16, 1999, GAO presented its findings in a report entitled, "Single-Family Housing: Weaknesses in HUD's Oversight of the FHA Appraisal Process."

(a) *HUD Has Limited Assurance That Appraisers Are Familiar With FHA's Appraisal Requirements*

Only appraisers approved by FHA may evaluate homes for FHA insurance endorsement purposes. To be eligible for FHA's roster of approved appraisers, appraisers must be State licensed or certified in accordance with the minimum criteria established by the Appraiser Qualifications Board of the Appraisal Foundation. The Qualifications Board's minimum licensing criteria require that appraisers have 90 hours of classroom education in subjects related to real estate appraisals, have 2,000 hours of appraisal experience, and pass the Qualifications Board's endorsed examination or an equivalent examination.

Unlike appraisals for conventional mortgages, appraisals for FHA-insured mortgages must include an assessment of the properties' compliance with FHA's property standards as well as appropriate and specific actions to correct conditions not in compliance with these standards. In addition, the value that an appraiser assigns to a property must reflect its value with all the required repairs completed.

HUD relies largely on the States' licensing process to ensure that appraisers are qualified. The States' minimum licensing standards, however, do not include proficiency in FHA's appraisal requirements. In conjunction with its Homebuyer Protection Plan, HUD developed a new appraisal report, known as the "valuation condition" report, to record the results of appraisals. The new report lists specific physical conditions for which the appraiser should check, and requires the appraiser to recommend whether a complete home inspection or some other type of more specific inspection (e.g., electrical, roofing, or structural) should be conducted. HUD will require lenders to provide a summary of this appraisal report to home buyers so that they will have information about needed repairs and recommended inspections.

HUD has also implemented a requirement that appraisers pass a test on FHA appraisal requirements and procedures in order to be deemed qualified to appraise FHA-backed properties. Some questions remain about the efficacy of this solution, however. During the Subcommittee's investigation, staff was informed by a number of experienced appraisers that the new FHA-required test is much too easy to pass. Moreover, some appraisers were permitted to take the test in an "open book" setting. Under the circumstances, therefore, it is hard to tell whether this test will appreciably increase the quality of appraisals at FHA-backed properties.

(b) *HUD's Monitoring of Appraisers Is Limited*

GAO found that HUD was not doing a good job of monitoring the performance of appraisers, thereby limiting its ability to assess the quality of appraisals used to qualify properties for FHA-insured loans. For example, the Philadelphia and Denver HOCs' records for 126 field reviews that rated appraisals as "poor" showed that HUD

nonetheless approved mortgage insurance for 96 of the homes covered by these unsatisfactory reviews. (In 37 of the 96 cases, the field reviews were performed after mortgage insurance had been approved.)

Specifically, GAO found that weaknesses existed in the scope of field review coverage. In September 1997, HUD established a policy requiring its field offices and their successors, the HOCs, to conduct field reviews of no less than 10 percent of the appraisals conducted within their jurisdictions. In fiscal year 1998, HUD performed about 81,000 of these reviews, but three out of the four HOCs did not meet the 10 percent requirement in fiscal year 1998. HUD also did not conduct field reviews of the work of many of the appraisers with the highest workloads. For example, HUD did not field review the work of thousands of appraisers who conducted 10 or more FHA appraisals during the period from October 1, 1997, through June 30, 1998. While HUD's procedures do not require field reviews for appraisers doing a higher volume of appraisals, higher-volume appraisers presumably inherently have less time to spend on any particular appraisal. Since HUD never bothered to assess the performance of these high-volume appraisers, however, it had little assurance that those appraisers were conducting accurate and thorough work.

Philadelphia and Denver HOC officials told GAO that several factors contributed to problems with field review coverage. These factors included: (1) HUD's reliance upon contractors to conduct field reviews and the unavailability of contract funds during the first several months of the fiscal year; (2) the reassignment of personnel during HUD's reorganization, which, in some instances, left no one responsible for ordering field reviews; and (3) the lack of emphasis that some field offices placed on field reviews once they knew their functions would be transferred to the HOCs.

GAO also found that many field reviews were not timely—a problem that appears to have gotten worse over time. Although HUD guidance states that timeliness is essential to ensure quality field reviews, half of the field reviews conducted in fiscal year 1998 did not occur until at least 77 days after the appraisals had been performed. In six of HUD's field office jurisdictions, the corresponding figure was 140 days or more. (By contrast, HUD reported in fiscal year 1997 that all field reviews were being completed within 45 days of the appraisals.) Philadelphia and Denver HOC officials plausibly told GAO that the reduced timeliness of field reviews made it difficult to prevent the approval of FHA mortgage insurance for loans based on faulty appraisals and reduced the usefulness of field review reports as a monitoring and enforcement tool.

In addition, GAO found that HUD's oversight of field review contractors was limited. At the Philadelphia and Denver HOCs, HUD staff did not routinely visit appraised properties to verify the observations of field review contractors or take other measures systematically to evaluate the contractors' performance. Officials at both the Philadelphia and Denver HOCs told GAO that they rarely conducted such evaluations because they lacked sufficient staff and travel resources. As a result, they neither tracked the percentage of each contractor's work that received an on-site review nor evalu-

ated contractors' performance with a numerical rating system.[147] (Because HUD found it difficult to monitor such a large number of contracts—estimated at 250—it planned to contract out the field review function to a small number of large appraisal firms. It also planned to have HUD staff perform quality assurance reviews of the contractors.)

Moreover, GAO found that the Philadelphia and Denver HOCs did not fully implement HUD guidance on handling and tracking consumers' complaints, including those relating to appraisals. In October 1998, HUD officials told GAO that the Philadelphia HOC was developing a set of written procedures for all four HOCs to follow. GAO found that the Philadelphia and Denver HOCs did not have complaint tracking systems containing the information required by the December 1997 policy memorandum. Both HOCs maintained logs showing, among other things, the HOC official assigned to follow up on a complaint and the date the follow-up action was completed. These logs did not include other required information, however, such as the nature of the complaint, the actions taken to address it, or the final disposition of the complaint. (If made available, this information would enable HOC management readily to determine the frequency of different types of complaints and ensure that all complaints were being resolved in an appropriate manner.) As a result of GAO's work, however, HUD implemented changes to help ensure the recording of this information. According to departmental officials, these changes have greatly improved the HOCs' ability to handle complaints.

GAO concluded that the weaknesses it found in HUD's oversight of the FHA appraisal process increased FHA's risk of insuring properties that are overvalued or whose owners may default on their FHA-insured loans because of unexpected repair costs. The consequence of this increased risk is higher potential losses to FHA's insurance fund. GAO recommended that HUD achieve better field review coverage of FHA's appraiser roster by (1) ensuring that each HOC reviews the required percentage (currently 10 percent) of the FHA appraisals conducted annually within its geographic jurisdiction, and (2) requiring that when selecting appraisals for field review, HUD staff give higher priority to the work of appraisers who have done a substantial number of FHA appraisals but have not been field-reviewed within the past year. GAO also recommended that HUD make field reviews of appraisals more timely by establishing a process to ensure that HUD staff obtains copies of appraisal reports and perform field reviews prior to FHA's approval of mortgage insurance. In addition, GAO recommended that HUD better assess the quality of appraisal field reviews by insuring that a portion of each field review contractor's work is verified through on-site evaluation of properties reviewed by the contractor.

In commenting upon GAO's recommendation that HUD achieve better field review coverage of FHA's appraiser roster, HUD indicated that it would implement a revised field review process by

[147] HUD's policy guidance stresses the importance of evaluating the work of field review contractors and states that 5 percent of every contractor's work should be reviewed and rated on scale from 1 to 5 (with 1 being unacceptable and 5 being excellent). The purpose of this rating system is to document performance problems and justify disciplinary actions against field review contractors, if necessary.

July 1, 1999, to improve its sampling and targeting of appraisers for field review. In response to GAO's recommendation that HUD conduct on-site evaluations of a portion of each field review contractor's work, HUD indicated that it would begin performing supervisory reviews of contractors in conjunction with a national field review contract scheduled to begin in July 1999. Implementation of both of these changes was delayed until March 2000. HUD disagreed with GAO's recommendation to improve the timeliness of appraisal field reviews by obtaining copies of the appraisal reports and performing field reviews prior to loan closings and the approval of FHA mortgage insurance. HUD indicated that the collection of all appraisals and the performance of field reviews before the approval of mortgage insurance would be impractical and inconsistent with HUD's Direct Endorsement Program, which allows qualified mortgagees to process and close FHA loans without prior review by HUD. In turn, GAO modified this recommendation to reflect the fact that it may be difficult for HUD to field review appraisals before the lenders close on the loans.

(c) *HUD Sanctioned Few Poorly-Performing Appraisers*

GAO found that HUD was not holding appraisers accountable for the quality of their appraisals. A poor field review score (i.e., a score of 1 or 2 on the abovementioned 1 to 5 scale) indicates that the appraiser did not adequately support the value assigned to the home, overlooked serious repair conditions, and/or made other errors and omissions that could result in an unacceptable insurance risk to FHA. A poor field review rating indicates that HUD's HOCs may impose an administrative sanction, called a limited denial of participation, that bars an appraiser from participating in FHA programs for up to 1 year. HUD's policy states that appraisers who receive two or more poor scores in field reviews during any 12-month period should be issued a limited denial of participation temporarily prohibiting them from conducting further FHA appraisals for a period of time determined by FHA.

Despite the danger of allowing poor appraisers to continue conducting FHA appraisals, however, appraisers who received two or more poor ratings in field reviews were frequently not prohibited from conducting additional FHA appraisals. During the first three quarters of fiscal year 1998, 246 of the 5,768 field-reviewed appraisers within the Philadelphia and Denver HOCs' jurisdictions received two or more poor field review scores. As of the end of that fiscal year on October 1, 1998, however, HUD had issued limited denials of participation to only 11 of those 246 appraisers.

GAO found that poor record-keeping by HUD field offices was the primary reason for the HOCs' inability to pursue enforcement actions against other poorly performing appraisers. HUD's policy was apparently to sanction appraisers only when there existed substantial evidence and documentation of performance that is less than acceptable. Philadelphia and Denver HOC officials told GAO, however, that a lack of supporting documentation had hampered their efforts to sanction appraisers. GAO verified this assertion through its review of appraisers' files at both the Philadelphia and Denver HOCs. This GAO review disclosed that most of the field review re-

ports supporting the poor field review scores recorded in HUD's files were missing altogether.

GAO concluded that HUD's ability to sanction poorly-performing appraisers was seriously impaired by the loss or misplacement of records prior to and during HUD's field consolidation. Consequently, hundreds of appraisers whose work may be creating an unreasonable underwriting risk for FHA apparently continued to conduct appraisals for FHA-insured mortgages.

(d) *HUD Has Not Aggressively Enforced Its Policy on Lender Accountability for Appraisals*

HUD's policy is that lenders are responsible, equally with the appraisers they select, for the accuracy and thoroughness of appraisals. In October 1994, HUD issued regulations implementing a legislative provision that allowed lenders to choose the appraisers of properties to be insured by FHA. While the legislation did not address this issue, HUD's regulations stated that lenders who selected their own appraisers were equally responsible, along with the appraisers, for the accuracy, integrity, and thoroughness of the appraisals. In May 1996, HUD repealed these regulations as part of a larger Federal effort to reduce the regulatory burden of participating in government programs. According to HUD, the regulations were not necessary because many of the standards in the regulations were already in HUD's handbook guidance and mortgagee letters issued to lenders. Despite the repeal, therefore, it remained HUD policy to hold lenders accountable for the actions of the appraisers they select.

Accordingly, HUD issued mortgagee letters to lenders in November 1994 and again in May and November 1997 reiterating its policy that lenders were equally responsible for the quality of appraisals. HUD's Deputy Assistant Secretary also indicated that the failure of a lender voluntarily to resolve the appraisal deficiencies raised by HUD would result in enforcement action against the lender—including probation and suspension.

Nevertheless, according to GAO, HUD did not aggressively enforce this policy because of disagreement within HUD over its authority to do so. In May 1998, the Philadelphia HOC requested that HUD's Mortgagee Review Board sanction a lender who refused to correct property deficiencies that an appraiser had overlooked. This was the first case of this type that had been referred to the Board. Ultimately, however, the Board never reviewed or acted on this request because its staff was concerned that HUD might now have the authority to hold a lender accountable for the quality of an appraisal simply because the lender selected the appraiser in question. As a result, HOCs became reluctant to refer similar cases to the Board.

To improve HUD's oversight of lenders participating in FHA's programs, GAO recommended that HUD (1) determine the extent of its authority to hold FHA-approved lenders accountable for poor-quality FHA appraisals performed by the appraisers they select from FHA's roster, and (2) issue policy guidance that sets forth the specific circumstances under which HUD may exercise this authority. HUD responded that it would target for monitoring those lenders that used poorly performing appraisers.

B. *HUD's Office of the Inspector General*

HUD's/OIG, led by Inspector General Susan Gaffney, has been vocal in its criticism of HUD's management of the Single Family Mortgage Insurance Program. The OIG notes that HUD has undertaken major structural and organizational changes in single family operations over the last 5 years. These changes include the consolidation of field operations into the four HOCs, significant staffing cuts in headquarters and field operations, and the delegation to contractors of major portions of its workload. During this period of change, the single family program has been particularly vulnerable to fraud, waste, and abuse. Fortunately, a high mortgage insurance premium structure, FHA's abandonment of traditional insurance fund mutuality principles, and a very strong economy in the late 1990's enabled FHA easily to meet its capital reserve requirements. An economic downturn, however, could seriously affect the financial well-being of FHA's mortgage insurance fund.[148]

Over the past 2 years—through audits, investigations, and its Housing Fraud Initiative,[149]—the HUD/OIG has examined nearly every aspect of the single family program. All in all the OIG feels that its work clearly demonstrates (1) a high incidence of fraud, waste, and abuse in FHA's single family operations, and (2) a clear need for HUD to tighten controls over this multi-billion dollar mortgage-insurance program.[150]

In 1999, HUD/OIG audited the Loss Mitigation Program. This audit found a growing use of loss mitigation tools by servicing lenders, but a lack of program oversight by HUD staff. Loss mitigation tools, of course, are intended to help prevent foreclosures. Yet, while the use of these tools has more than tripled in fiscal year 1999, HUD's foreclosure rates continue to rise. The National Delinquency Survey conducted by the Mortgage Bankers Association showed a 39 percent rise in FHA foreclosure rates over 5 years, from 1.45 percent at the end of calendar year 1994 to 2.01 percent at the end of calendar year 1999. During the same period, MBA data show an increase of about 19 percent in FHA delinquency rates, from 7.26 percent to 8.61.

The OIG acknowledged that HUD has developed two measures that may strengthen the FHA program. One is the Homebuyer Protection Plan, which is designed to protect borrowers from bad appraisals. The other is the Credit Watch program, which is discussed at length above, which terminates lenders with excessive default rates from FHA programs. Both plans, however, are relatively new, and thus a thorough evaluation has not yet been done. Moreover, although the Homebuyer Protection Plan is making

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[148] Office of Inspector General, U.S. Department of Housing and Urban Development, *Semiannual Report to the Congress* (October 1, 1999-March 31, 2000) [hereinafter *"HUD/OIG, 1999–2000 Semiannual"*], at 2.

[149] The OIG's Housing Fraud Initiative ("HFI") is described as "a proactive law enforcement effort using a unified approach to the detection and prosecution of fraud in HUD programs." HUD/OIG, *1999–2000 Semiannual, supra,* at 12. HFI seeks to combine OIG audit and investigative resources with the investigative and prosecutive skills of the Federal Bureau of Investigation (FBI) and U.S. Attorney's Offices in designated Federal judicial districts in order better to root out fraud in HUD-funded activities. HFI was the result of concern by members of the House Appropriations Subcommittee on VA, HUD, and Independent Agencies that HUD funds may not be reaching those needing Federal assistance due to pervasive fraud. HFI began in October 1998 with the designation of six Federal judicial districts to serve as initial HFI sites.

[150] *Id.* at 2.

strides to improve the quality of appraisals, the enforcement aspect of the plan has been slow to develop. The Credit Watch Program will also take action only against those lenders with the most egregious default record. Very few actions have been taken to date, and—as discussed in more detail above—two actions terminating lenders have led to serious legal challenges by the lenders. Moreover, neither of these initiative substitutes the need for HUD staff to better monitor lender performance.[151]

HUD/OIG's audit and investigative work have disclosed that HUD's current procedures for monitoring lenders and conducting oversight of contractors are less than effective. In HUD/OIG's view, this lack of oversight clearly contributes to fraud and abuse of the FHA Single Family Program. This is because FHA's mortgage insurance risk depends almost exclusively on the reliability of work performed by its DE lenders, who underwrite nearly all FHA insurance. FHA mitigates its risk through lender oversight. Three important HUD monitoring tools should be working to prevent the insurance of fraudulent loans: Post endorsement technical reviews of loan underwriting documentation, field reviews of appraisals, and quality assurance reviews of lenders. When used effectively, these tools can highlight problem loans or lenders. The OIG has found, however, that HUDs monitoring was not properly focused upon lender and appraiser high risk indicators. Instead, HUD merely emphasized meeting numerical review goals set forth in its Business and Operating Plan.[152]

(1) *Post-Endorsement Technical Reviews*

Post-endorsement technical reviews underwriting and property appraisals are key controls in monitoring DE lenders. These technical reviews typically consist of a desk review of FHA case documentation after insurance endorsement to assess lender compliance with HUD underwriting and appraisal requirements. HUD has retained contractors to perform most of this work at a price ranging from $15 to $35 per case.[153] If the technical review discloses an improper endorsement or other problems, then HUD staff is supposed to take remedial actions—e.g., seeking identification from lenders for loans not meeting FHA endorsement criteria or referring lenders to the Quality Assurance Division for on-site review.[154]

The OIG, however, found that HUD relied too uncritically upon the work of these contractors and did not do enough to review contractor performance. The effects of such over-reliance were demonstrated in a recent case in which Allstate Mortgage Company fraudulently originated over 400 FHA loans totaling $97 million. Seventeen of these loans had undergone post-endorsement reviews by a contractor. The contractor found no significant problems with these loans, even though the loan files showed obvious fraud indicators. None of these 17 cases had even been re-examined by HUD contract monitors.[155]

The OIG's reexamination of 151 post-endorsement reviews found that 70 of these reviews failed to disclose material underwriting er-

[151] *Id.*
[152] *Id.* at 4.
[153] *Id.*
[154] HUD/OIG, *Single Family Production Home Ownership Centers, supra* at 7.
[155] HUD/OIG, *1999–2000 Semiannual,* at 4.

rors. Thirty-two reviews failed to identify significant fraud indicia.[156] The OIG review found several reasons why HUD's controls over the post-endorsement technical review process were not providing meaningful results. These included: The presence of inexperienced staff in critical HUD control positions; increased loan volume accompanied by the allocation of fewer staff members for monitoring lenders; the lack of clear operating policies or procedures for HOC operations; outdated handbooks; emphasis on quantitative goals; and the existence of financial disincentives for contractors to find problematic endorsements. Even when significant technical review problems were noted, the OIG found HUD implemented few, if any, corrective actions.[157]

(2) *Post-Endorsement Field Reviews of Appraisals*

Another critical control feature is the systematic testing of property appraisals by HUD. The DE lender selects the appraiser that sets the value of the property for FHA insurance. With the high loan-to-value ratio of most FHA loans, an accurate appraisal is critical to minimizing HUD's insurance risk. HUD's procedures call for field reviews of 10 percent of all appraisals,[158] and 5 percent of each appraiser's work.[159] In addition, all appraisers receiving a "poor" rating during the post-endorsement technical review process are supposed to be subject to field review.[160]

The OIG found, however, that the HOCs did not have a systematic procedure for selecting appraisals for review to ensure that the required 5 percent of each appraiser's work was reviewed. This is because the HOCs did not have contracts for field review of appraisals in all areas of their jurisdictions. Moreover, lenders did not always provide a second copy of the appraisal (as they were required to do) and appraisal reports were not always complete—though this apparently did not stop the HOCs from accepting the cases instead of rejecting them. In addition, the OIG found that the HOCs' primary emphasis was upon being able to declare that they had completed their goal of completing field reviews of 10 percent of the total appraisals. Little emphasis, it seems, was put on ensuring that the program was working properly.[161]

Even when field reviews disclosed problems with appraisers, HUD failed to use the results to take action. Branch chiefs at three of the four HOCs told the OIG that they did not have enough staff to monitor appraisers or to sanction poor performers. As a result of these deficiencies, HUD lacks assurance about the quality of appraisals supporting loans processed and approved by lenders.[162] For example, as of March 30, 2000, two appraisers named in a criminal indictment returned against the principals of Allstate Mortgage Company in December 1997—appraisers who apparently provided numerous fraudulent appraisals—had not been removed from HUD's approved appraiser listing, issued a limited denial of

[156] *Id.* at 32.
[157] *Id.* at 4.
[158] *Id.* at 5.
[159] HUD/OIG, *Single Family Production Home Ownership Centers, supra* at 38.
[160] *Id.*
[161] *Id.* at 39.
[162] HUD/OIG, *1999–2000 Semiannual, supra,* at 5.

participation, or debarred.[163] HUD's lack of action against problem appraisers is also evident from its own numbers. According to HUD's Single Family Data Warehouse information system, during the 2-year period ending September 30, 1999, 15,526 appraisals received "poor" desk review ratings. However, 13,007, or 83.8 percent, of these appraisals were never subjected to field review.[164] Instead, these poor ratings were entered into HUD's database without any subsequent action.[165]

(3) *Quality Assurance Reviews*

A third important control over DE lender activity is on-site monitoring reviews. These reviews, which are conducted by the HOCs' Quality Assurance Divisions (QADs), are intended to identify and correct poor origination practices. After completion, the QADs communicate their review results to lenders and request written responses. Lenders are asked to explain the problems noted, list actions taken to prevent future problems, and/or agree to indemnify HUD for possible losses associated with improperly originated loans.

This process, too, appears to have been impeded by poor HUD oversight. While the QADs are supposed to focus upon lenders with high default and foreclosure rates, the OIG discovered that the QADs instead reviewed numerous low-risk lenders because this permitted them more easily to claim that they had met HUD's numeric review goals. Even when the QADs identified deficiencies during on-site reviews, they did not follow-up when lenders failed to respond to their findings and recommendations.[166] The OIG also determined that the Approval/Recertification/Review Tracking System (ARRTS) HUD uses to track the status and results of QAD reviews contained significant errors, and therefore did not provide sufficient accountability for audit and staff evaluation purposes.[167]

VI. *HUD's False Promises to the Subcommittee*

The Subcommittee's hearings on the subject of mortgage flipping focused upon these and other related problems of HUD oversight of the FHA-back single family loan program. Faced with this criticism—and the numerous GAO and Office of Inspector General findings during the past several years demonstrating HUD's failure properly to protect the program against fraud, waste, and abuse—FHA Commissioner Apgar reassured the Subcommittee in sweeping terms on June 30, 2000 about the steps HUD has taken to combat flipping the assistance his agency would provide to help victims of mortgage fraud.

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[163] The individuals indicted included Douglas Estrada (the president and owner of Allstate Mortgage), Victor Noval (the owner of Noval and Associates and four other companies used in straw purchases), Shirley da Silva (Noval's ex-wife), James Weatherley (a former Oakland Raiders football player who located properties and straw buyers), Louis Valladares (a loan officer at Allstate Mortgage) and Alberto Jose Rivas (another loan officer at Allstate Mortgage Company). Allstate Mortgage was not itself indicted, and action by the Mortgagee Review Board appears to be pending the results of the criminal case against the principals. PSI staff has learned that the two appraisers are both engaged in plea negotiations with the U.S. Attorney's Office.

[164] HUD/OIG, *Single Family Production Home Ownership Centers, supra,* at 42.

[165] *Id.* at 43.

[166] Office of Inspector General, U.S. Department of Housing and Urban Development, *Semiannual Report to the Congress 5* (October 1, 1999-March 31, 2000).

[167] Office of Inspector General, U.S. Department of Housing and Urban Development, *Semiannual Report to the Congress 32–33* (October 1, 1999-March 31, 2000).

In his testimony, Apgar discussed Credit Watch and the Homebuyer Protection Plan as being particularly promising initiatives, but took particular pains to promise that HUD would in fact compel the restructuring of mortgages the value of which had been artificially inflated by "flipping" schemes of the sort outlined hereinabove. Specifically, Commissioner Apgar declared that:

> "HUD will move aggressively to force lenders to restructure inflated mortgages that result from fraudulent appraisals or the so-called property flips. We will push the loan back to the lender and make him responsible for producing a loan that the borrower can afford. If not, the FHA will intervene directly and make the loan right for the borrower."[168]

Despite his promises, however, this promised relief had yet to appear more than a year later. When Apgar, a Clinton Administration appointee, left HUD early in 2001 along with Secretary Andrew Cuomo, nothing had been done.

The Subcommittee has since learned that Apgar's promises to the Subcommittee, and to borrowers across the country, appear to have been empty ones. According to information provided to the Subcommittee by HUD official Laurie Maggiano, in fact, Apgar couldn't possibly have followed through on his sweeping reassurances because the law *prevents* HUD from forcing lenders to reduce loans that FHA insures. On May 14, 2001, Maggiano advised Senator Barbara Mikulski that in Apgar's Subcommittee testimony a year previously, "FHA perhaps over committed what it was able to deliver." Apgar's disingenuous promises, therefore, stand perhaps as the final legacy of Secretary Cuomo and his fellow Clinton Administration appointees at the Department of Housing and Urban Development—a legacy of lax oversight and poor management upon which the Subcommittee Minority hopes new HUD Secretary Mel Martinez and the Bush Administration will be able greatly to improve.

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[168] Hearing record, supra, at 45.