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Statement of James A. Heist, Assistant Inspector General for Audit
Department of Housing and Urban Development
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Chairwoman Waters, Ranking Member Miller, and members of the Subcommittee, thank you for inviting me to testify today. I am Jim Heist, Assistant Inspector General for Audit at the Department of Housing and Urban Development, Office of Inspector General (HUD OIG).

Background

The Department's Federal Housing Administration (FHA), is one of the largest mortgage insurers in the world, providing coverage to over 34 million home mortgages since 1934. FHA insurance protects HUD-approved lenders against losses should a homeowner default on their mortgage loans. FHA insured loans also offer borrowers the financing advantages of low downpayments and underwriting guidelines that recognize the future earning potential and credit challenges of many first-time homebuyers.

On April 7, 1998, HUD's Office of General Counsel issued a legal opinion on seller funded 'gifts' or downpayment assistance provided through nonprofit organizations. That decision, which confirmed that the Nehemiah Homeownership Program was not in conflict with FHA's guidelines for downpayment assistance, has materially impacted the FHA portfolio. Nehemiah and similar nonprofit programs provide the 3 percent 'downpayment' required by law of FHA borrowers at closing. The seller makes a charitable contribution to the nonprofit equal to the downpayment plus a processing fee. In reality, the 'donation' is not a true gift because it is typically a condition placed on the seller in order to complete the sale. To fund the 'gift,' the seller typically raises the selling price of the home to cover the gift amount.

Nonprofit seller funded downpayment assistance to FHA borrowers made up less than 1 percent of all mortgage loans that were originated in 1998 and, therefore, constituted little risk to FHA insurance fund. By 2006, however, the concentration of nonprofit downpayment assistance approached 25 percent of FHA's new business portfolio, including purchase and refinance loans. The default and claim rates for these nonprofit assisted loans are twice as high as 'no gift' loans, and this adverse performance has become a serious financial concern to the Department. I will discuss later in my testimony the impact that this has had on FHA's fiscal year 2008 budget submission.

The Department has recently proposed regulatory changes that would establish specific standards for an FHA borrower's investment in a property for which the mortgage is insured by FHA. The Office of Inspector General strongly supports the Department and believes that, if made final, the regulation will stop this practice and strengthen the financial viability of FHA. It is, therefore, critical that the Department not make material changes to the proposed regulations or, as was done in 1999, withdraw a similar proposed rule.

My testimony today will focus on the reasons the Office of Inspector General supports the Department's decision to end nonprofit seller funded downpayment assistance in FHA lending.

The Record

The Office of Inspector General raised concerns about FHA's acceptance of Nehemiah and similar nonprofit downpayment programs in 1999. We initially questioned the validity of the 'nonprofit gift' as a quid pro quo transaction rather than one made gratuitously without consideration, as fits the definition of a gift. OIG has conducted substantial audit work at selected FHA lenders that approved loans with nonprofit downpayment assistance. Three examples provide evidence of how these programs can adversely impact FHA borrowers:

- America's Mortgage Resource, Inc. (Audit Report No. 2006-FW-1006; March 28, 2006). A branch manager formed an identity-of-interest nonprofit entity (Imagine Foundation) to provide gifts for loans initiated by America's Mortgage. However, Imagine was never granted nonprofit eligibility by the IRS as its downpayment gift program was determined not to provide a charitable service. Nevertheless, America's Mortgage closed 73 FHA loans with downpayment gifts through Imagine, 38 percent of which were seller funded through increased sales prices. The markups ranged from $1,000 to $13,000 depending on the cash needs of the borrowers to close the loans. Imagine collected a 1 percent processing fee for each of the ineligible gifts.

- K Hovnanian (Audit Report No. 2006-FW-1004; January 26, 2006). In this case, a K Hovnanian identify-of-interest homebuilding company provided gifts to nonprofits for loans underwritten by a K Hovnanian lender. K Hovnanian funded the gifts by increasing the sales prices of the homes. While the downpayment assistance program did not violate FHA rules, K Hovnanian did agree to refund the fees inappropriately charged to the borrowers.

- Broad Street Mortgage (Audit Report No. 2005-FW-1010; May 26, 2005). Audit testing of the lender's loan files found documentary evidence showing that sellers increased sales prices to cover the cost of 'donations' to downpayment assistance providers. Correspondence between lender staff cited specific amounts needed from sellers to close the loan, and the price markups required to fund the sellers 'gifts.'

The results of these and other audits have validated our early findings on the overall program risk to the FHA insurance fund associated with nonprofit downpayment assistance. We conducted two comprehensive analyses looking in depth at these downpayment loans, and the associated program risks, as these loans increasingly consumed a larger share of FHA loan originations:

- Final report of nationwide audit, Down Payment Assistance Programs, Office of Insured Single Family Housing (Audit Report No. 2000-SE-121-0001, March 31, 2000). We initiated this audit in response to citizen concerns about HUD-approved nonprofit downpayment assistance programs. Audit results concluded that HUD allowed nonprofit organizations to operate down payment assistance programs that circumvented FHA requirements. The downpayment loan transactions did not meet the intent of FHA requirements in that the down payment assistance was not a true gift from the nonprofit; default rates for buyers receiving down payment assistance from nonprofit organizations were significantly higher than for other FHA loans; and, sellers raised the sales prices of properties to cover the cost of the down payment assistance programs causing buyers to finance higher loan amounts.

  We recommended that HUD implement a proposed rule to eliminate seller funded nonprofit downpayment programs.

- Follow up to Down Payment Assistance Programs Operated by Private Nonprofit Entities, (Audit Report No. 2002-SE-0001, September 25, 2002). Based on a request from the General Deputy Assistant Secretary for Housing, we reviewed a statistical sample of 1,125 FHA case files to determine the percentage of borrowers receiving down payment assistance from nonprofit corporations, and to find out if the downpayment-assisted loans were more likely to default than loans without such assistance. For these types of loans, the seller or builder reimburses the nonprofit organization for the assistance. The audit found that downpayment-assisted loans have a greater tendency to default than unassisted FHA loans. We also found that information in HUD's Single Family Data Warehouse was often inaccurate, and that stronger controls were needed to ensure that lenders enter correct information so that HUD can effectively evaluate the performance of downpayment-assisted loans and the associated risk to the FHA fund.

  We recommended that HUD implement a rule prohibiting seller-derived down payment assistance loans, and strengthen controls to improve data accuracy. Because of the data limitations disclosed in this report, we also concurred with FHA’s plans at the time to conduct more extensive analyses of downpayment assisted loans.

We have not been the only voice of concern.

The Government Accountability Office (GAO) cautioned in November 2005 (Report No. GAO-06-24) that FHA needed to better manage the risks of FHA-insured loans with downpayment assistance. Like our early findings, GAO's analysis showed that loans with assistance from seller funded nonprofits did not perform as well as loans with assistance from family or other sources. Moreover, this difference can be explained, in part, by the higher sales prices of comparable homes bought with seller funded assistance. Recent GAO testimony before the U.S. Senate Subcommittee on Transportation, Housing and Urban Development and Related Agencies, Committee on Appropriations (GAO-07-615T) emphasized the urgency of actions needed to manage financial risks of loans with downpayment assistance. I quote: "Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of downpayment assistance from nonprofit organizations that receive part of their funding from home sellers. According to FHA, high claim and loss rates for loans with this type of downpayment assistance were major reasons for changing the estimated credit subsidy rate from negative to positive for fiscal year 2008."

FHA's actuaries have also commented on the impact of downpayment assisted loans in the actuarial study of the Mutual Mortgage Insurance (MMI) Fund for fiscal year 2005. Their conclusion -- an almost $2 billion (7 percent) decrease in the estimated economic value.

HUD's contractors, in response to our 2000 and 2002 audit findings, conducted an independent analysis in 2004 focusing primarily on loans where nonprofit organizations provided the gift funds to the borrowers. Their conclusion -- median house prices and seller contributions tended to be higher when gifts from nonprofits were present.

Lastly, the Internal Revenue Service (IRS) issued a May 26, 2006, revenue ruling that nonprofit organizations that fund downpayment assistance programs with contributions from the property sellers do not meet legal requirements for tax-exempt status. The IRS concluded that these assistance programs were not charities, that the seller funded gifts did not proceed from detached and disinterested giving, but rather were made in response to an anticipated economic benefit, namely facilitating the sale of a seller's home. The IRS is currently conducting a large number of investigations of organizations involved in such activities.

FHA Risk

FHA single family lending has experienced a marked drop in insurance volume, as subprime lending spiked and mortgage interest rates increased. For the Department, the numbers are disconcerting: in fiscal year 2006 insurance in force (active mortgages) was down 8 percent, new endorsements were off 17 percent, and delinquency and default rates inched upward. Of concern is the increased incidence and poor performance of seller funded nonprofit downpayment-assisted loans in FHA's portfolio as illustrated by the following statistics from the fiscal year 2006 independent actuarial study of FHA's MMI Fund.

Exhibit IV-9

Concentration of Loans with Gift Letter by Sources (Percent)[a]					
Origination Year	No Gift	Relative	Non-profit, Religious, or Community	Government Assistance	Employer
1998	77.60	21.87	0.19	0.31	0.03
1999	82.20	16.32	0.55	0.86	0.06
2000	77.17	18.81	1.83	2.10	0.09
2001	83.23	11.08	4.26	1.36	0.07
2002	82.26	9.15	7.05	1.48	0.06
2003	81.35	7.41	9.76	1.42	0.06
2004	70.24	9.59	18.05	2.04	0.08
2005	63.88	9.49	23.52	3.03	0.08
2006[b]	61.31	9.62	25.10	3.87	0.10

Source: FHA data warehouse, February 28, 2006 extract.
[a] In percentage of all MMI Fund endorsed loans, including purchase and refinance loans. The concentration rate of gift loans would be much higher if refinance loans were excluded from this calculation.
[b] Based on partial year data.

Exhibit IV-10

Cumulative Claim Rates of Loans with Different Gift Sources (Percent)					
Origination Year	No Gift	Relative	Non-profit, Religious, or Community	Government Assistance	Employer
1998	4.64	8.04	7.50	9.35	9.12
1999	4.55	7.59	12.16	11.39	8.15
2000	5.70	8.01	15.10	12.27	8.80
2001	4.18	5.67	13.66	11.25	7.05
2002	2.78	3.37	9.71	7.42	4.93
2003	1.45	1.91	5.99	4.70	2.62
2004	0.80	0.90	2.66	1.43	1.37
2005	0.10	0.09	0.35	0.15	0.25

Source: FHA data warehouse, February 28, 2006 extract.

The cumulative insurance claim rates illustrate that downpayment assisted loans represent a significantly greater risk to FHA than 'no gift' loans. For each origination year, claim rates for loans receiving downpayment assistance from non-profit groups is significantly greater than claim rates associated with no gifts. It takes several years for each year's business to experience claims that might arise. Therefore, the most recent years have lower rates that can be expected to increase as the loans mature.

Impact on FHA Borrowers

The Department has committed to a schedule that will result in a final rule being issued next summer to address the practice of seller-assisted downpayments. The proposed rule has been published for public comment. Yet it is important to note that until this rule is issued, the status quo remains the same and nonprofit down payment assisted loans will continue to have a negative impact on the economic value of the MMI Fund and on FHA borrowers. The looming impact on FHA borrowers is highlighted in FHA's fiscal year 2008 budget submission. It states: "*Because of adverse loan performance and improved estimation techniques, the base line credit subsidy rate for FHA's single family program – assuming no programmatic changes – is positive, <u>meaning that total costs exceed receipts on a present value basis, and therefore would require appropriations of credit subsidy budget authority to continue operation</u>. The 2008 baseline includes no budget authority to cover these costs and assumes FHA would use its existing authorities to increase premiums to avoid the need for credit subsidy appropriation*."

This adverse loan performance, as highlighted in GAO's November report, is primarily attributable to the poor performance of seller funded nonprofit downpayment assisted loans. Simply put, under the requirements of the Credit Reform Act, FHA is left with only two choices, to request a new appropriation (when it has not needed one previously) or to increase its premiums to avoid a shortfall. When the HUD Inspector General testified a few months ago before the Committee on Appropriations regarding the vitality of the FHA program, they were very concerned about having to find the funds for a new appropriation to cover this shortfall. Since HUD has indicated that it would not seek appropriations, this burden will, therefore, fall on all FHA borrowers through increased mortgage insurance premiums.

I recognize that the Subcommittee will hear other testimony highlighting the growth of homeownership opportunities through nonprofit downpayment programs. However, as noted above, the growth in the percentage of FHA loans with downpayment assistance comes at a price. Moreover, ongoing events in the mortgage industry have taught an important lesson about lending practices. It is the borrower who often suffers the most when financed into a home at an inflated value because the sales price was raised to pay for the nonprofit gift. Here are some examples from recent audits of FHA lenders' loan origination activities:

> <u>**Case #1**</u>. This FHA loan involved an $8,500 'gift.' The borrowers were aware that the mortgage amount was going to be increased by the assistance they received from the nonprofit organization. In our interview, the borrowers told us they first asked the homebuilder for help with the closing costs, and were directed to a lender. The lender's representative told them that downpayment funds were available, but that the loan amount would be increased to cover the downpayment.

The borrowers were told that the downpayment would be repaid through their mortgage payments. They were not told that the assistance was supposed to be a 'gift.' They signed a gift letter at closing, but did not know it said the borrowers were under no obligation to repay the assistance. They did know that the sales contract stated: "The seller to pay up to $8,500 towards the Buyers Fund."

Case #2. This FHA loan involved a $7,183 'gift.' The seller prepared two different sales contracts. The borrowers showed the auditors a copy of the first sales contract. The price of the home was $82,900, which was consistent with the homebuilder's price list. The contract stipulated that the seller would pay for the title policy if the buyer used the seller's preferred lender. The second sales contract showed the price of the home at $88,425, and that the seller would pay up to $7,183 toward the "Buyer's Fund." The borrowers agreed to use the seller's preferred lender. The borrowers told the auditors they were not aware they were receiving a gift and did not know about the increase in the sales price until after loan closing when they looked at the paperwork.

Neither borrower was able to keep current on their inflated mortgage loans and eventually lost their homes to foreclosure.

To prevent a repetition of what these borrowers experienced, and to help address the looming shortfall projected in the fiscal year 2008 budget, FHA should implement the proposed rule to end seller funded nonprofit gifts.

That concludes my testimony and I thank the Subcommittee for holding this hearing and I look forward to answering questions that Members may have.