



**TESTIMONY OF THE  
HONORABLE KENNETH M. DONOHUE, SR.  
INSPECTOR GENERAL  
DEPARTMENT OF HOUSING AND  
URBAN DEVELOPMENT**

**BEFORE THE UNITED STATES  
HOUSE OF REPRESENTATIVES  
SUBCOMMITTEE ON OVERSIGHT  
AND INVESTIGATIONS  
COMMITTEE ON FINANCIAL SERVICES  
MARCH 10, 2005**

**Testimony of the  
Honorable Kenneth M. Donohue, Sr.  
Inspector General  
U.S. Department of Housing and Urban Development**

**Before the United States  
House of Representatives  
Subcommittee on Oversight and Investigations  
Committee on Financial Services  
March 10, 2005**

Madame Chairwoman Kelly, Ranking Member Gutierrez, and other members of the Subcommittee, good morning. I am pleased to have this opportunity to bring to the Subcommittee's attention the facts surrounding a recent case developed by the HUD Office of Inspector General and other law enforcement agencies against First Beneficial Mortgage Corporation of Charlotte, North Carolina, and its importance as an area of concern for government sponsored enterprises, regulatory agencies and those that oversee these organizations.

The story of First Beneficial is not simply the story of greed and a major fraud against various victims. The First Beneficial story is also not only a story of earnest detective work and interagency law enforcement cooperation and collaboration, although this case certainly has that element.

**The Players**

By First Beneficial I mean not only the owners but also the corrupt underwriters, accountants and others who made this fraud possible by willingly becoming accomplices to the crime.

Of importance are the crimes of the owners and associates of First Beneficial. But also important is the lack of due diligence by some to take action to mitigate harm against the Government.

For whatever reasons, Fannie Mae (Federal National Mortgage Association) did not pass information on First Beneficial's transgressions to others, which allowed First Beneficial to continue to operate and to issue over \$7.5 million in fraudulent mortgage-backed securities (MBS) guaranteed by Ginnie Mae (Government National Mortgage Association).

Fannie Mae is a private, shareholder-owned company that works to make sure mortgage money is available for lenders. Fannie Mae stock (FNM) is actively traded on the New York Stock Exchange and other exchanges and is part of the Standard & Poor's 500 Composite Stock Price Index. Fannie Mae is a private company operating with private capital on a self-sustaining basis chartered by Congress to direct efforts at increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans. Fannie Mae receives no government funding or backing.

Ginnie Mae channels global capital into the nation's housing markets. Specifically, the Ginnie Mae guaranty allows mortgage lenders to obtain a better price for their mortgage loans in the secondary market. The lenders can then use the proceeds to make new mortgage loans available. Ginnie Mae does not buy or sell loans or issue MBS. Ginnie Mae guarantees securities issued by approved issuers. Ginnie Mae guarantees investors the timely payment of principal and interest on MBS backed by federally insured or guaranteed loans — mainly loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA). Ginnie Mae securities are the *only* MBS to carry the full faith and credit guaranty of the United States government.

### **The First Beneficial Crime**

On the easel is a flow chart of the case, which shows in a compressed fashion the timeline of the events I will now discuss. Fannie Mae approved First Beneficial as a single-family mortgage lender in 1995. In 1997, First Beneficial was approved to sell Title I loans. Title I loans are home improvement loans and manufactured housing loans. In 1998 (See timeline exhibit), Fannie Mae was noticing problems with the Title I loan program nationwide and decided to review First Beneficial's loan portfolio. This review uncovered approximately \$1 million in ineligible Title I loans to people without FHA-insured mortgages.

During this review, First Beneficial was not truthful about whether the Title I loans were FHA insured. At this time, Fannie Mae demanded First Beneficial repurchase the portfolio but First Beneficial did not have the funds to repurchase. Fannie Mae worked out a deal where they would purchase new pre-approved single-family loans from First Beneficial and apply the proceeds from the sale of these loans to repurchase the ineligible Title I loans. Fannie Mae placed an in-house suspension on First Beneficial at this time.

After a few weeks, First Beneficial called Fannie Mae and said they had an investor who was willing to buy the bad Title I loans with a single cash payment. Accordingly, in September of 1998 First Beneficial paid Fannie Mae back the nearly \$1 million. First Beneficial did not disclose the source of the funds, nor did Fannie Mae demand an answer.

At this point in 1998 (See timeline exhibit), Fannie Mae did become suspicious of First Beneficial's single-family loans as well and began an inquiry into those it had purchased. They found that many loans were in the names of First Beneficial's owners and employees and that should have caused Fannie Mae concern. First Beneficial said that the loans were 'investor' loans and that they would repurchase them.

On November 3, 1998, Fannie Mae wrote First Beneficial and said they would not purchase any more of their loans without prior approval.

On November 19, 1998, Fannie Mae received a telephone call from a financial crimes investigator with the North Carolina Banking Commission who told them that First Beneficial was making loans without insurance and that First Beneficial was trying to get Ginnie Mae to buy the loans. The investigator gave Fannie Mae the names of two First Beneficial employees, who confirmed their effort to sell loans to Ginnie Mae.

Fannie Mae learned that First Beneficial had only two investor sources – Fannie Mae and Ginnie Mae.

On November 20, 1998, Fannie Mae suspended First Beneficial as a lender and called in the owner for a meeting. At this meeting, Fannie allegedly wanted to know more about the investors but received no response from First Beneficial. Following this meeting, Fannie Mae did some review by taking the addresses of properties in the loan portfolio and going out to inspect.

What they discovered was that many of the properties listed were, in fact, vacant lots. A check at the courthouse revealed that the named borrowers did not own the properties and that some were not even owned by First Beneficial.

At this point, it is my understanding; Fannie was not under any legal obligation to notify Ginnie Mae, OFHEO, or any law enforcement agency

such as the OIG or FBI. However, I believe that a good corporate citizen should have done so.

Fannie Mae had some knowledge that many of the loans were secured by non-existent houses on land that was not owned by the borrowers. Fannie Mae allowed First Beneficial to repurchase their ineligible loans using the proceeds of a sale to another unwitting purchaser.

In late 2000, Ginnie Mae discovered these transactions through a subsequent compliance audit. Because Fannie Mae did not tell Ginnie Mae the dubious scruples of this lender, the original fraud to Fannie Mae ballooned in costs to Ginnie Mae. By the time it was all said and done, the American taxpayer was defrauded out of approximately \$38 million.

Essential to the scheme was the requirement that First Beneficial provide a mortgage document to the Ginnie Mae document custodian. As you can see from the exhibit on the easel for property listed as “9108 Pleasant Ridge, Charlotte, N.C.,” this appears to be at first glance a normal mortgage note. In reality, there was no such mortgage and the signature belongs to a relative of the owner of First Beneficial. The collateral listed on the note was a vacant lot (See picture exhibit) not owned by the stated mortgagor. This is one example of numerous false mortgages created by First Beneficial and backing MBS through the Ginnie Mae program.

Four defendants have been convicted and sentenced. I am happy to report that the ringleader James McLean received one of the largest white-collar sentences in U.S. history. Defendant McLean was sentenced to 21 years in prison and \$23.5 million in restitution was ordered.

In December 2004, a Consent Order was filed providing that Fannie Mae pay \$7,500,000 to the Government as part of ill-gotten gains generated through First Beneficial’s criminal activities. An additional 200 individual victims associated with First Beneficial fraud have been, or soon, will be paid restitution in full from assets seized in the case.

Some might say this case is about a small amount or could be interpreted as the cost of doing business particularly as it relates to the vast funds in the securities markets. But you can see from the severe sentence, that the Court viewed this case as a serious matter. The full faith and credit of the United States stands behind Ginnie Mae and it is the integrity of the program that

investors rely upon. The First Beneficial case impacts on the integrity and, if allowed to happen again, wears away at the faith that investors put into this program. No rule or regulation or law existed that made it incumbent on Fannie Mae to have told others what they discovered. But if they had, it may have saved taxpayers millions of dollars.

### **Types of Mortgage Fraud of Concern to the HUD/OIG**

While the centerpiece of this case involves false statements and the creation of fictitious mortgages, we in the HUD/OIG are concerned with a multitude of unlawful and deceptive practices and outright frauds in mortgage lending particularly those that exploit FHA borrowers. As we testified last fall before this Committee, some of these practices include:

- Appraisers valuing properties for much more than they are worth.
- Loan officers falsifying income and credit documents.
- Lenders charging fees for services not provided or unnecessary.
- Realtors deceiving the potential homebuyer of the property condition.
- Borrowers duped into re-financing their mortgages over and over until the equity is completely stripped from the property.
- Using stolen or purchased social security numbers and/or credit histories.

Of particular concern is the illegal profiteering on the purchase and quick resale of homes called “property flipping.” The illegality arises because parties to the transaction (seller, loan officer, appraiser) conspire to inflate the value of the home and then pocket the excessive profits at loan closing.

Another concern is “equity skimming.” A common form involves an investor who exploits a homeowner facing foreclosure and financial stress. How is this done?

- Investor offers to resolve the financial problems if the homeowner gives up ownership or an ownership share in the property.
- Homeowner agrees to pay rent to the investor and the investor promises to make the mortgage payments.
- Investor pockets the rent and makes no mortgage payments.
- Lender forecloses on the homeowner (investor’s ownership interest not recorded).

- Investor uses bankruptcy laws to stay foreclosure.

## **Conclusion**

For six years I worked as an Assistant Director for Investigations with the Resolution Trust Corporation to resolve the Savings and Loans failures. One of the few positive things to arise from that financial collapse was that regulatory agencies, the Department of Justice, the Department of Treasury and others began coordinating their information about economic information in the form of a Suspicious Activity Report, created a National Bank Fraud Working Group, and instituted a practice of a continuing dialogue and communication among organizations with like interests.

This effort was designed to try to forestall or to prevent such a destructive event from occurring again. Through cooperation and self-reporting of problems confidence in the marketplace is fostered. I have spoken to outside counsels who have reported to me that too often mortgage lender problems are not referred to the appropriate investigative, audit or regulatory organization for correction or civil litigation. A major lesson learned here, and one that highlights a systemic weakness that needs to be addressed, is that had better communication existed between Fannie Mae and Ginnie Mae, the American people might not have incurred such a loss.

\*\*\*\*\*

The HUD Office of Inspector General is charged with locating system weaknesses and recommending either legislative or administrative corrections to promote efficiency and economy in HUD and related programs. I hope we have highlighted an area where action and responsibility needs to be taken.

In closing, I offer my thanks to the Departments of Justice and Treasury and to the IRS Criminal Investigations Division for its help and support in developing this important case.