OFFICE OF AUDIT
REGION 9
LOS ANGELES, CA

City of Long Beach, CA

Recovery Act Neighborhood Stabilization Program 2 Grant

2012-LA-1012

SEPTEMBER 21, 2012

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Audit Report Number: 2012-LA-1012

TO: William Vasquez, Director, Los Angeles Office of Community Planning and Development, 9DD

///SIGNED///

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Los Angeles Region, 9DGA

SUBJECT: The City of Long Beach, CA, Did Not Fully Comply With Federal Regulations When Administering Its NSP2 Grant

Enclosed is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final results of our review of the City of Long Beach's Neighborhood Stabilization Program 2 (NSP2).

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at (213) 534-2471.

September 21, 2012

The City of Long Beach, CA, Did Not Fully Comply With Federal Regulations When Administering Its NSP2 Grant

Highlights

Audit Report 2012-LA-1012

What We Audited and Why

We conducted an audit of the City of Long Beach because it was awarded more than $22.2 million in Recovery and Reinvestment Act of 2009 NSP2 funds on February 11, 2010 as the lead agency in a consortium with Habitat for Humanity of Greater Los Angeles (Habitat), making it one of the largest NSP2 fund recipients in the Los Angeles area. Our objective was to determine whether the City of Long Beach administered its NSP2 grant in accordance with Federal regulations.

What We Recommend

We recommend that the Director of the Los Angeles Office of Community Planning and Development require the City to reimburse the NSP2 program $84,110 from non-Federal funds, and implement procedures and controls to ensure that its appraisals meet program timeframe requirements.

What We Found

We found no problems with the $5.5 million the City provided to Habitat, used to purchase and redevelop abandoned or foreclosed-upon homes. However, the City did not fully comply with Federal regulations when administering its NSP2 second mortgage assistance activities. Specifically, it did not (1) obtain the 1-percent market rate purchase discount on non-real-estate-owned properties and (2) have all properties appraised within 60 days of the final offer.

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BACKGROUND AND OBJECTIVE

The Neighborhood Stabilization Program 2 (NSP2) was authorized under Title XII of Division A of the American Recovery and Reinvestment Act of 2009 and provided 56 grants nationwide on a competitive basis totaling $1.93 billion. NSP2 was established to stabilize neighborhoods, the viability of which has been and continues to be damaged by the economic effects of properties that have been foreclosed upon and abandoned. The NSP2 grant recipients included local governments, nonprofits, consortiums, and one State.

The City of Long Beach was awarded more than $22.2 million in NSP2 funds as the lead member in a consortium with Habitat for Humanity of Greater Los Angeles to revitalize targeted neighborhoods. Habitat was to use 25 percent of the grant to purchase, rehabilitate, and resell vacant and foreclosed-upon homes to families earning less than 50 percent of the area median income. The City planned to use the rest of the funds to serve households earning up to 120 percent of area median income. The City allocated $14.4 million to provide second mortgage assistance to low- and moderate-income families to aid with the acquisition of a foreclosed-upon single-family home in Long Beach. The maximum loan amount for low-income families was $200,000, and the maximum loan amount for middle- or moderate-income families was $77,540. The City would also provide grants of up to $10,000 for closing costs and $30,000 for Green-Lite and code-related rehabilitation. As of July 17, 2012, the City had drawn $11.1 million from the grant specific to the second mortgage assistance program and $4.5 million for Habitat, for a total of $15.6 million.

Our objective was to determine whether the City administered its NSP2 grant in accordance with Federal regulations. Specifically, we focused on whether (1) home-buyer purchases under the City's second mortgage assistance program received the required purchase discounts and (2) the homes purchased were appraised within 60 days of the final offer.

RESULTS OF AUDIT

Finding 1: The City Did Not Fully Comply With Regulations When Administering Its NSP2 Activities

The City did not fully comply with Federal regulations when administering its second mortgage assistance program. Specifically, it did not ensure that (1) home buyers received a 1-percent purchase discount from the current market appraised value of the homes and (2) property appraisals were conducted within 60 days of the final offer. These conditions occurred because the City's NSP2 policies and procedures manual contained incorrect information regarding the purchase discount. Also, the City had inadequate controls to ensure that it followed its policies and procedures and Federal regulations regarding appraisals of NSP2 grant properties. As a result, $84,110 could have been used toward helping additional home buyers, and the City was not assured that its home buyers received the best price for homes purchased.

1-Percent Discount Not Always Taken

Our review of all 69 homes purchased as of March 30, 2012, through the second mortgage assistance program found that a total of 27 homes (nearly 40 percent) were purchased without the required 1-percent purchase discount. The Notice of Funding Availability for NSP2 required all foreclosed-upon homes or residential properties to be purchased at a discount of at least 1 percent (see appendix C). Of the 27 homes that did not receive the purchase discount, 26 were short sales, and 1 was a real estate-owned property owned by the U.S. Department of Housing and Urban Development (HUD). Further, 3 of the 27 homes received a discount, but the amount of the discount was less than 1 percent. As a result, $84,110 could have been used toward helping additional home buyers with silent second mortgages, closing cost assistance, or rehabilitation costs.

Property purchase amounts overpaid

Property	1% purchase discount amount	Discount amount taken	Amount overpaid
1	$3,350	$0	$3,350
2	$2,300	$0	$2,300
3	$3,500	$0	$3,500
4	$3,750	$0	$3,750
5	$3,800	$0	$3,800
6	$3,550	$0	$3,550
7	$3,400	$(1,000)	$2,400
8	$3,900	$0	$3,900
9	$3,650	$0	$3,650
10	$4,500	$0	$4,500
11	$3,150	$0	$3,150
12	$3,400	$0	$3,400
13	$3,350	$0	$3,350
14	$2,200	$0	$2,200
15	$3,350	$0	$3,350
16	$3,650	$0	$3,650
17	$3,300	$0	$3,300
18	$2,200	$0	$2,200
19	$2,100	$0	$2,100
20	$2,750	$0	$2,750
21	$2,850	$0	$2,850
22	$2,690	$0	$2,690
23	$4,120	$(2,000)	$2,120
24	$2,800	$0	$2,800
25	$3,000	$0	$3,000
26	$4,650	$(2,000)	$2,650
27	$3,850	$0	$3,850
Total	**$89,110**	**$(5,000)**	**$84,110**

The City's NSP2 policies and procedures did not match Federal requirements. The City's policies and procedures stated that the purchase price for real estate-owned homes must be at least 1-percent less than the current appraised market value of the home, but the one percent discount did not apply to those homes that are not an REO property (see Appendix C). The City was not able to provide a reason why its policies and procedures did not meet program requirements for non-REO properties. Subsequent to our bringing this to the City's attention, the City updated its policies and procedures as of June 4, 2012, to reflect all acquisitions (short sales and REOs) must receive the 1-percent purchase discount.[1]

[1] We did not review properties acquired after June 5, 2012, to confirm whether the City had adequately implemented the new procedures (see Scope and Methodology).

Appraisals Not Always Performed Within 60 Days of Final Offer

Our review of 69 files revealed that properties purchased by the homebuyers as part of the Second Mortgage Assistance program were not always appraised within 60 days of the final offer. We found 15 files in which the appraisals were performed from 7 to 145 days after the 60-day requirement with the average number of days being 54. This deficiency was contrary to requirements of both the City's NSP2 policies and procedures and Federal regulations. The City's NSP2 policies and procedures manual stated, "The date of the appraisal must be within 60 days of the finalization of the purchase offer." Federal requirements also stated that appraisals were to be completed within 60 days of the offer.

The purpose of appraisals for homes purchased under the NSP2 grant is to ensure that purchasers pay below-market value for the home or property. Therefore, if the appraisal is not conducted within 60 days, HUD cannot be reasonably assured that the home is purchased for below-market value. When we inquired about the matter, the City's grant administration officer appeared to be unaware that any of the second mortgage assistance program homes were not appraised within 60 days of the final offer. Additionally, he stated that the industry standard was 120 days. However, this was not the requirement in the City's procedures, and 5 of the 15 homes' appraisals were also completed beyond the 120-day standard cited, as highlighted in the table below.

Late appraisals

Property	Total number of days	Appraisal was later than 60 days
1	75	15
2	71	11
3	123	63
4	67	7
5	116	56
6	164	104
7	101	41
8	160	100
9	73	13
10	110	50
11	85	25
12	192	132
13	205	145
14	105	45
15	71	11
Average number of days late		**54.3**

Conclusion

The City did not fully comply with Federal regulations when administering its second mortgage assistance program. It allowed 27 homes to be purchased by home buyers who did not receive the required 1-percent purchase discount. Further, the City did not follow its own policies and procedures or Federal regulations requiring appraisals to be conducted within 60 days of the final offer. As a result, $84,110 could have been used toward helping additional home buyers, and the City was not assured that home buyers received the best price for homes purchased.

Recommendations

We recommend that the Director of the Los Angeles Office of Community Planning and Development require the City to:

1A. Reimburse the NSP2 program $84,110 from non-Federal funds for the excess amount paid on 27 properties that were not purchased at the required 1-percent discount from the current market appraised value.

1B. Follow up with the City to ensure that homes purchased after June 5, 2012 received the 1-percent discount for subsequent NSP2 property purchases and specifically for short sale properties.

1C. Implement procedures and controls to prevent future occurrences of appraisals being conducted more than 60 days after the final offer.

SCOPE AND METHODOLOGY

We performed our onsite work at the City's Department of Development Services Neighborhood Services Bureau located at 100 West Broadway, Suite 550, Long Beach, CA, between March and August 2012. The audit scope covered the period February 11, 2010, through March 30, 2012, and was extended as necessary. Our objective was to determine whether the City complied with Federal requirements when administering its NSP2 grant.

To accomplish our audit objective, we

- Reviewed relevant HUD NSP2 regulations.
- Reviewed the City's policies and procedures pertaining to its NSP2 grant.
- Reviewed the NSP2 grant agreement.
- Reviewed the Consortium Agreement between the City and Habitat.
- Reviewed the City's audited financial statements and single audit reports for 2009 and 2010.
- Reviewed Habitat's audited financial statements for 2008, 2009, and 2010.
- Obtained and reviewed pertinent information from the DRGR.
- Analyzed and reviewed property files from Habitat.
- Reviewed program expenditures.
- Interviewed key personnel from the City and HUD.
- Analyzed and reviewed the entire population of 69 files for homes purchased through March 30, 2012.

Initially, we selected two separate samples, one for the second mortgage assistance program and one for Habitat. We selected a random sample of 10 properties for the SMA program because this would allow us to review nearly 15 percent of the population. We selected a random sample of 5 properties for Habitat because this would allow us to review 40 percent of the population and would give us an opportunity to review at least one file from each activity, such as properties sold, construction completed, and construction in progress. After our preliminary review of the second mortgage assistance properties, we reviewed the entire population of 69 files, which was the number of homes purchased under the program as of March 30, 2012. We reviewed each file to determine whether the home was purchased with the 1-percent purchase discount and whether the appraisal was performed within 60 days of the final offer or residential purchase agreement. There were no problems found with the Habitat files reviewed.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

INTERNAL CONTROLS

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Controls over compliance with Federal laws and regulations.
- Controls over the City's policies and procedures.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Significant Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- The City did not fully comply with Federal regulations when administering activities specific to home purchases (finding 1).
- The City did not comply with its own NSP2 policies and procedures specific to appraisals (finding 1).

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Ineligible 1/
1A	$84,110

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation	**Auditee Comments**
	September 6, 2012 United States Department of Housing and Urban Development Office of Inspector General Attention: Tanya E. Schulze, Regional Inspector General for Audit 611 West Sixth Street, Suite 1160 Los Angeles, CA 90017 **Introduction** The Neighborhood Stabilization Program 2 (NSP2) is a grant award to the City from the United States Department Housing and Urban Development (HUD) that is intended to stem the tide of foreclosures and short sales and allow these homes to be purchased by qualified first time homebuyers. The City is not directly acquiring the properties, but is instead using the NSP2 funds to provide financing mechanisms to assist these first-time homebuyers and increase the level of home ownership in the City. The Office of Inspector General (OIG) recently concluded a review of the City's NSP2. During the course of this review, the OIG identified two findings related to program implementation. The purpose of this communication is to respond to these findings and explain the genesis of the implementation procedures, as well as to identify mitigation and corrective actions that were undertaken to align the program with the identified regulations. **Response** The first component of the OIG finding is entitled *The City Did Not Obtain The Required One-Percent Market Rate Discount on Properties*. In describing the condition related to this part of the finding, the OIG states that the City did not ensure the one-percent market-rate discount for non-real estate owned properties as a result of incorrect information in the City's NSP2 policies and procedures manual.
Comment 1	The City would like to take this opportunity to clarify that it was cognizant of the discount requirement and initially included it in the earliest versions of the policies and procedures manual. This can be substantiated and documented by earlier versions of the manual. However, the City realized difficulty in implementing this requirement as it related to non-real estate owned (i.e. short sale) properties during the early stages of the program, and the City approached the HUD regional office in Los Angeles through

its Community Planning and Development representative for NSP2 to discuss the matter.

During this discussion, City staff enumerated the following impediments and how they made it difficult to implement the discount requirement vis-à-vis non-real estate owned transactions.

- In the short sale transactions, the purchase price negotiation occurred directly between the buyer, seller, and the seller's lien-holder/mortgagee. The mortgagees were already agreeing to take losses based on the amounts owed by the sellers. As part of the banking industry's standard procedures, appraisals were not ordered until after these lengthy negotiation processes were completed and the purchase agreements fully executed, and mortgagees were not amenable to reopening the negotiation process to accommodate the one-percent discount requirement.

- The mortgagee also bore the expense of several settlement charge expenses, most notably real estate commissions, that routinely reduced the lender's net sale proceeds by 5 to 8 percent per transaction. This analysis was performed by City staff and can be substantiated. Moreover, it shows that the City was not unduly enriching the mortgagees at the expense of the homebuyers.

Comment 2

During communication with the HUD representative regarding the above described impediments, the City understood that it was acceptable to exempt short sale transactions from the one-percent discount requirement. This led to a change to the original policies and procedures manual, allowing short sales to be exempted from the one-percent discount requirement. It was this version of the policies and procedures manual that was reviewed and documented by the OIG as described in their finding.

Comment 3

However, during the OIG monitoring, the City was told that the regulations had not been changed to exempt short sales from the one-percent discount and the City immediately instituted corrective action, including notification of NSP2 stakeholders and revision of policies and procedures manual.

The other component of the OIG finding is entitled *The City Did Not Have All Properties Appraised Within 60 Days Of The Final Offer*. In its NSP2 Second Mortgage Assistance Program (SMAP), the City has worked with realtors and lenders who serve as the initial points of contact for NSP2-assisted homebuyers. Homebuyers first pursued financing approvals through these community partners and have come to conduct their NSP2-funded real estate transactions in accordance with current industry standards, which assess an appraisal's age to determine whether it is less than 120 days old at the time of escrow's close.

Comment 4

It was not the City's intention to willfully violate any NSP2 regulations. However, in this case, there were no damages and the mistake led to a more efficient, better-designed method of capturing fair market value. The City recognizes that the primary purpose of the NSP2 appraisal requirement is to ensure cost reasonableness of the purchase price. Because market conditions in real estate are prone to change, an appraisal issued more than 60 days after the open of escrow, but before any funds are disbursed at close of escrow, is beneficial to the program. In other words, an appraisal issued closer to the close of escrow is more accurate in terms of representing the true current market value of the property. By consistently obtaining appraisals after escrow opened, and ensuring that they were updated by close of escrow, the City has complied with the spirit and intention of this cost reasonableness requirement. During the OIG monitoring period, HUD released a new directive, more closely aligned with the City's implementation of the requirement, that further explained the purpose of NSP appraisals and clarified that appraisals completed more than 120 days prior to the close of escrow must be updated for NSP2-funded transactions.

The City incorporated this policy clarification as of March 15, 2012, the release of the guidance from HUD. Furthermore, procedures regarding the requirement for updated appraisals for those older than 60 days at close and new full appraisals for those aged more than 120 days at escrow have been incorporated into the City's policies and procedures manual and disseminated to all NSP2 stakeholders.

Conclusion

It is never the City's intention to violate federal regulations, and this has been shown through the City's diligence in adhering to many similarly complex NSP2 regulations that were assessed as part of this review. Furthermore, the City would like to take this opportunity to express our gratitude for the professionalism that was accorded to the City by OIG staff.

Sincerely,

Patrick H. West
City Manager

OIG Evaluation of Auditee Comments

Comment 1 The City did not provide the OIG with "earlier versions" of its policies and procedures manual during the course of audit field work or as part of its comments. The City has only provided the policies and procedures in effect during our audit period, and the revised procedures discussed in the report. As a result, we cannot confirm whether prior versions appropriately included the discount requirement.

Comment 2 No documentation has been provided by the City to support this conversation took place between the City and HUD.

Comment 3 We agree that the City did promptly change its policies and procedures once we notified the City of the issue.

Comment 4 HUD did release additional guidance during the course of audit field work, further clarifying the need for updating appraisals in the event of delayed closing. However, the new directive did not change the timeframe requirements for obtaining an appraisal within 60 days of final offer. Not obtaining appraisals within the required timeframes increases the risk that the grantee may not be meeting statutory NSP discount requirements and that homebuyers may not be receiving the best price.

Appendix C

CRITERIA

The Notice of Funding Availability for NSP2 under the American Recovery and Reinvestment Act of 2009, Docket No. FR-5321-N-01, Appendix I(A):

Current market appraised value. The current market appraised value means the value of a foreclosed upon home or residential property that is established through an appraisal made in conformity with the appraisal requirements of the URA [Uniform Relocation Assistance and Real Property Acquisition Policies Act] at 49 CFR [Code of Federal Regulations] 24.103 and completed within 60 days prior to an offer made for the property by a recipient, subrecipient, developer, or individual homebuyer; provided, however, if the anticipated value of the proposed acquisition is estimated at $25,000 or less, the current market appraised value of the property may be established by a valuation of the property that is based on a review of available data and is made by a person the recipient determines is qualified to make the valuation.

(Q). Purchase discount

Background

Section 2301(d)(1) limits the purchase price of a foreclosed home, as follows:
"Any purchase of a foreclosed upon home or residential property under this section shall be at a discount from the current market appraised value of the home or property, taking into account its current condition, and such discount shall ensure that purchasers are paying below-market value for the home or property."

To ensure that uncertainty over the meaning of this section does not delay program implementation, HUD is defining "current market appraised value" in this notice. For mortgagee foreclosed properties, HUD is requiring that recipients seek to obtain the "maximum reasonable discount" from the mortgagee, taking into consideration likely "carrying costs" of the mortgagee if it were to not sell the property to the recipient or subrecipient. HUD has adopted an approach that requires a minimum discount of one percent for each residential property purchased with NSP funds and a minimum average discount of five percent for all residential properties purchased with NSP2 funds during the three year expenditure period.

Requirements

1. Individual purchase transaction. Each foreclosed-upon home or residential property shall be purchased at a discount of at least one percent from the current market-appraised value of the home or property.

City of Long Beach NSP2 Policies and Procedures Manual, Module 4 – Acquisition (I)(A)(2):

The purchase price of the Real Estate Owned (REO) home must be at least 1% less than the current appraised market value of the home. The 1% discount does not apply to those homes that are not an REO property.

HUD's Guide to Property Acquisitions in NSP Programs (5):

(C) Estimate of Property Value; Appraisals
While it is not required for voluntary acquisitions in an NSP program at the pre-offer state, it is advisable to obtain a professional evaluation of the as-is market value of the property to determine the cost-reasonableness of the asking price or proposed offer price. Brokers' opinions and electronic appraisals are examples of low-cost assessments that might be used for the purpose of informing offers.

With voluntary acquisitions, as an alternative to the informal appraisal above, obtain a full URA-compliant appraisal if the property is foreclosed upon and the buyer plans to execute a sales agreement on the property within 60 days. For foreclosed properties as defined by NSP, an appraisal must be completed within 60 days of an offer made for the property, to confirm that the offer or sale price is at least 1% below appraised value, as required by NSP. Some NSP buyers complete these before they make an initial offer, while others want to make sure the initial offer is accepted before they incur this cost prior to a final offer. If a full appraisal is required by NSP (remember, in voluntary acquisitions, they are only required for foreclosed properties) and if not obtained before making the offer, then the option or purchase agreement must be conditional upon receiving an appraisal that confirms that required discount.