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Audit Case Number	00-AT-123-0001

TO: William C. Apgar, Assistant Secretary for Housing-Federal Housing
Commissioner, H

FROM: Nancy H. Cooper
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Single-Family Property Disposition Program

This report presents the results of our nationwide internal audit of the Federal Housing Administration's (FHA) Single-Family Property Disposition Program. FHA's comments to the three findings and associated recommendations are included as Appendix B with excerpts and the Office of Inspector General's (OIG) response incorporated into the Findings and Recommendations section of the report.

Within 60 days, please provide a status report for each recommendation on: (1) the corrective action taken; (2) the proposed corrective action and a planned completion date; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued as a result of the audit. Note that Handbook 2000.06 REV-3 requires management decisions to be reached on all recommendations within 6 months of report issuance. It also provides guidance regarding interim actions and the format and content of your reply.

We appreciate the cooperation of your staff and the Management and Marketing (M&M) contractors during the audit. Should you or your staff have any questions, please contact me at (404) 331-3369, or Gerald Kirkland, Assistant District Inspector General for Audit, at (865) 545-4368.

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Executive Summary

This report presents the results of our nationwide internal audit of FHA's single family property disposition program. It is a compilation of external audit reports on seven M&M contractors as well as audit work performed at FHA's four homeownership centers (HOCs) and at the Department of Housing and Urban Development (HUD) Headquarters.

In response to the Secretary's "HUD 2020 Reorganization Plan," FHA outsourced the management and marketing of its single family properties. In March 1999, FHA awarded 7 companies a total of 16 M&M contracts to manage its single family property inventory. The program mission remained unchanged. It is to reduce the inventory in a manner that:

“(1) expands homeownership, (2) strengthens neighborhoods and communities, and (3) ensures a maximum return to the mortgage insurance fund.”

FHA has realized some success from outsourcing. Sales volume had increased and the number of properties in inventory was down. Also, contractors implemented new marketing tools such as bidding through the internet. Contractors also may be able to react more quickly to market fluctuation than previously. Despite these positive strides, FHA did not accomplish other core elements of its program mission. It did not maximize the return to the mortgage insurance fund or maintain properties in a manner that strengthened neighborhoods and communities. FHA has had numerous other problems with the contractors including bankruptcy by one, inability to meet contract performance deadlines, countless complaints from homebuyers and real estate professionals, and billings for ineligible costs. Employees of two contractors were arrested for taking kickbacks. Nevertheless, in his May 16, 2000, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Subcommittee on Housing and Transportation Assistant Secretary Apgar declared, *“Since assuming responsibility for all property management and marketing activities approximately one year ago, FHA's M&M contractors have performed extremely well by any measure commonly used in the real estate industry to evaluate performance.”* Our audit results indicate such optimism is premature and misleading. We found problems with all seven contracts we reviewed.

Our audit determined that outsourcing of program operations resulted in reduced returns to the mortgage insurance fund of about \$188 million. We attribute the losses to poor M&M contractor sales performance and substantially increased program costs. We believe FHA's failure to perform a cost benefit analysis in accordance with A-76 contributed to the poor program performance and loss of funds.

Our audit also confirmed what FHA has repeatedly found in its monthly performance assessment reports. As discussed in Finding 2, none of the contractors we audited managed properties according to contract requirements. Contractors did not perform timely initial inspections, perform adequate inspections, correct hazardous conditions, make repairs, or perform routine maintenance to preserve and protect properties. The poor property conditions decreased marketability, increased FHA's holding costs, negatively affected surrounding communities, reflected poorly on the Department, and in some cases, threatened the health and safety of the public. Although FHA repeatedly reported the deficiencies in its monthly performance assessment reports, it has not been successful in improving property conditions under private management.

As discussed in Finding 3, contractors did not comply with other contract requirements. For example, contractors did not obtain timely property appraisals, approve disposition programs timely, properly review HUD-1 Settlement Statements, or perform other contract requirements that are important to the successful accomplishment of the program mission. The noncompliance could significantly increase the risk of loss to the insurance fund.

FHA's property disposition program has undergone extensive review by OIG, the General Accounting Office (GAO) and KPMG LLP over the last several years. Each of us has recommended improvements we believe are essential to FHA's success. On certain issues, such as the recommendation to impose fines and penalties for violations of contract terms, our advice is unanimous. Based on the results of this most recent audit, it is evident the recommendations of prior reports are as important as ever.

FHA must continue to focus on achieving its primary mission at a price that protects the integrity of the insurance fund and the public trust. With this in mind, we are recommending that FHA:

- Establish performance benchmarks and critical success factors that show when the costs of outsourcing exceed the benefits obtained and consider alternative program delivery methods when the costs are not justified by the benefits;
- Revise GPRA goals to include accurate performance indicators;
- Not renew options for contractors who have proven unable or unwilling to comply with critical contract provisions; and
- Implement other controls to ensure efficient and effective operations.

FHA's response to the draft report

We provided FHA our draft report on September 1, 2000. We discussed the draft report with FHA officials at a September 7, 2000, exit conference. FHA provided written comments to the draft on September 15, 2000. FHA disagreed with Finding 1, but generally agreed with the other findings and the recommendations. We considered the comments in preparing our final report. The comments are summarized within each finding and included in their entirety as Appendix B.

Table of Contents

Management Memorandum	i
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Executive Summary	iii
-------------------	-----

Introduction	1
--------------	---

Findings

1	Outsourcing Resulted in Reduced Returns of \$188 Million	5
2	Contractors Did Not Adequately Maintain or Secure Properties	15
3	Contractors Violated Other Contract Requirements	27

Follow-Up on Prior Audits	31
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Appendices

A	Results of OIG Property Inspections	33
B	FHA Comments	35
C	Distribution	41

Abbreviations

CFR	Code of Federal Regulations
FHA	Federal Housing Administration
FY	Fiscal Year
GAO	General Accounting Office
GPRA	Government Performance and Results Act of 1993
HOC	Homeownership Center
HUD	U.S. Department of Housing and Urban Development
M&M	Management and Marketing
M&O	Maintenance and Operating
OIG	Office of Inspector General
OMB	Office of Management and Budget
REO	Real Estate Owned
SAMS	Single Family Acquired Asset Management System

Introduction

Background

FHA's Single Family Mortgage Insurance Program helps low and moderate income families become homeowners by reducing downpayments and limiting lender fees. Every year, however, thousands of borrowers default on their FHA-insured loans. When they default, FHA encourages lenders to work with them to bring their payments current. When they cannot do this, their homes may be sold to third parties, voluntarily conveyed to the lenders, or surrendered to lenders through foreclosure. Once lenders obtain the properties, they generally convey title to the Secretary of HUD in exchange for payment of their insurance claim. In fiscal year 1999, HUD acquired over 71,000 properties.

The National Housing Act of 1934 confers on the Secretary the authority to manage, rehabilitate, rent and dispose of its acquired single family properties. Section 204(g) of the Act governs the management and disposition of single family properties acquired by FHA. Title 24, Code of Federal Regulations (CFR), part 291 implements this statutory authority. Handbook 4310.5 REV-2, dated May 17, 1994, *Property Disposition Handbook - One to Four Family Properties*, supplements the regulations.

FHA disposes of properties through its Property Disposition Program. FHA's mission is to reduce the property inventory in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the insurance fund.

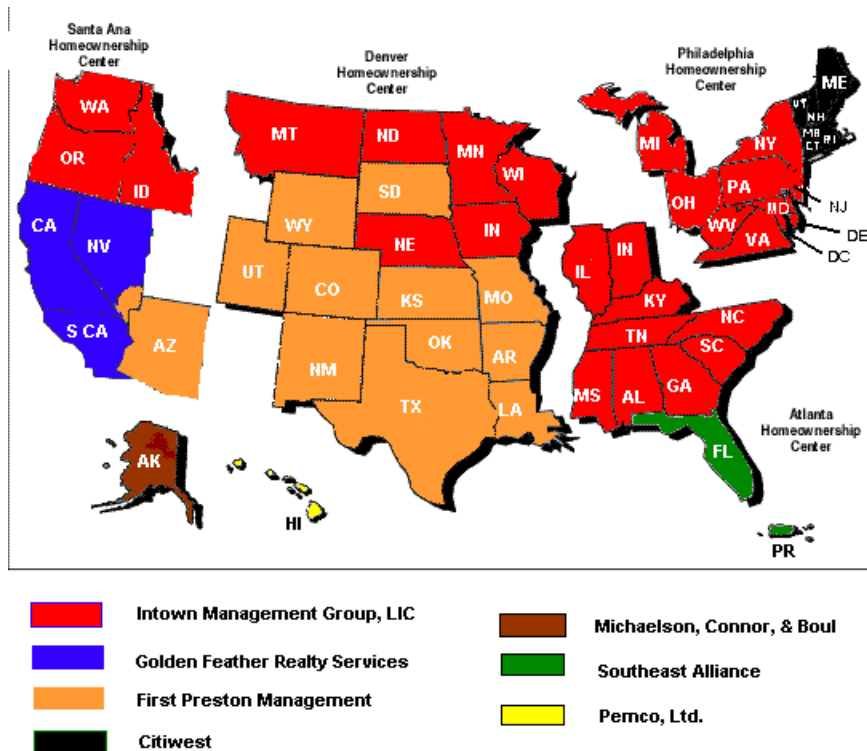
In 1993, the Commission on Reinventing Government produced the National Performance Review which promoted principles to enable all federal agencies to redefine their missions. The review recommended that HUD outsource its property disposition function in order to create higher returns. As a result of the review, Congress enacted the Government Performance and Results Act (GPRA) of 1993. The Act requires all federal agencies to set specific and measurable goals in performing their public missions.

As part of an effort to streamline operations and reduce costs in 1996, FHA began a pilot program to test the feasibility of contracting out its management and marketing services. FHA believed the costs and benefits evidenced by the pilot program demonstrated the effectiveness of the M&M approach. FHA considered the pilot a success and proceeded to award M&M contracts nationwide.

In March 1997, as part of HUD's continuing reinvention efforts, FHA issued its 2020 Field Consolidation Plan for Single Family Housing. In March 1999, FHA put the final phase of its reorganization efforts into effect. It awarded 7 companies a total of 16 M&M contracts to manage and market its properties nationwide. These contracts had an estimated 5-year value of \$927 million. The contractors became responsible for nearly all aspects of managing and marketing properties.

Contractor	Number of Contracts	Total Contract Amounts
InTown Management Group, LLC	7	\$ 367,043,965
Golden Feather Realty Services	2	282,820,352
First Preston Management, Inc.	3	151,048,609
Southeast Alliance of Foreclosure Specialists, LLC	1	78,919,923
Citiwest, New England, Inc.	1	41,582,249
PEMCO, Ltd.	1	2,889,406
Michaelson, Connor & Boul	1	2,828,132
Total	16	\$ 927,132,636

By the end of September 1999, HUD had terminated all seven of InTown Management Group's (InTown) contracts because of poor performance. InTown had been responsible for about 40 percent of FHA's initial property inventory. InTown's workload was turned over to other contractors or to FHA staff. In June 2000, HUD awarded two additional contracts to assume responsibility for some of the areas that FHA staff was administering.



We audited 7 of the 13 contracts in effect as of May 31, 2000.¹ This included 5 of the 6 remaining contractors. These contracts represented on average a total inventory of 31,837 properties or about 66 percent of the national average. FHA pays the contractors a fee based on a percent of the property sales prices. As of August 3, 2000, FHA had paid the contractors about \$234 million for their services related to these contracts.

The primary contract objectives are to ensure: (1) properties are protected and preserved, properly managed, evaluated, and marketed in a manner which produces the highest possible return to the insurance fund; (2) average losses on sales and the average time properties remain in inventory are reduced; and, (3) the overall program and the image of properties are positive.

FHA's Single Family Asset Management Division is responsible for developing property disposition policies and procedures governing program administration. Each of FHA's four HOCs is responsible for program operations within their geographical jurisdictions. The HOCs are located in Atlanta, Georgia; Denver, Colorado; Santa Ana, California; and Philadelphia, Pennsylvania. As of May 31, 2000, FHA had 40,552 properties in inventory valued at about \$3.6 billion.

Audit objectives and scope

The audit objectives were to determine if: (1) FHA and the contractors managed and marketed properties according to HUD policies, procedures and regulations and with the terms and conditions of the M&M contracts; (2) FHA and the contractors had adequate controls to ensure FHA's assets are adequately protected; and (3) operations resulted in FHA accomplishing its mission and performance goals.

To meet our objectives, we:

- Interviewed FHA and contractor officials;
- Reviewed Federal requirements including 24 CFR Part 291, HUD Handbook 4310.5 REV-2, *Property Disposition Handbook One to Four Families*, the *Monitoring Manual - Management Controls for the Single-Family REO M&M Contract*;
- Reviewed monthly Performance Assessment Reports and related correspondence;
- Reviewed a judgmental sample of contractor payment vouchers;
- Inspected a judgmental sample of 189 properties in 13 cities;
- Reviewed a judgmental sample of 138 active, 25 held off market, and 116 closed property cases files;

¹ We excluded InTown from our analysis. We also did not audit the two contracts awarded in June 2000.

- Reviewed contractors’ policies and procedures and observed their operations; and,
- Analyzed inventory, sales, and cost trends.²

We assessed contractors’ management controls over: (1) property preservation and protection, (2) billings to FHA for services, (3) property sales, (4) property appraisals, (5) review of sales closing documents, and (6) subcontracting. We also assessed FHA’s monitoring controls.

We issued external audit reports on seven contracts.

OIG DISTRICT PERFORMING AUDIT	CONTRACT AREA	CONTRACTOR
I	P1	Citiwest New England, Inc.
II	P3	First Preston Management
III	P2	Michaelson, Connor & Boul
IV	A3	Southeast Alliance of Foreclosure Specialists, LLC
V	A1	Golden Feather Realty
VIII	D3	First Preston Management, Inc
X	C1	Golden Feather Realty

The audits were performed from February through August 2000 and generally covered the activities from contract inception on March 29, 1999, through May 31, 2000.³ We expanded our scope to other periods as necessary to accomplish the audit objectives.

We conducted our audit in accordance with generally accepted government auditing standards.

² We excluded April and May 1999 from our analysis because data during those initial months of the contract were not representative of overall contractor performance.

³ We adjusted our scope to reflect the effective date of the InTown replacement contracts when appropriate.

Outsourcing Resulted in Reduced Returns of \$188 Million

FHA's sales data showed that outsourcing resulted in reduced returns to the insurance fund of \$188 million from June 1, 1999, to May 31, 2000. This occurred, in part, because M&M contractors' sales produced lower returns than FHA staff historically obtained prior to outsourcing operations. The poor sales performance accounted for \$103 million of the loss. Outsourcing also resulted in substantially increased program costs compared to prior FHA performance, reducing returns another \$85 million. FHA's decision not to perform a cost benefit analysis in accordance with A-76 may prove to be a costly mistake. We recommend FHA establish performance benchmarks and critical success factors that show when the costs of outsourcing exceed the benefits obtained. We also recommend FHA revise GPRA goals and reports to include all key performance indicators in order to provide an accurate assessment of program performance.

Performance measures

FHA measures performance by sales volume, inventory levels, sales to owner occupants, percent of appraised value realized upon property sale, and net recovery. These indicators provide information on FHA's success in meeting its mission. In its annual GPRA Performance Report, HUD cited management improvements as the factor which resulted in FHA's reaching its net recovery performance goal for FY 1999. It boasted that the net recovery rate increased about 12 percent for FY 1999 resulting in savings to the insurance fund. Net recovery is the per property average sales price less the per property average expenses. While average sales prices and net recovery have increased, this measure is not a valid assessment of performance or a reflection of success. In fact, although FHA claims success based on the indicators, it has not established performance benchmarks. Without benchmarks, it cannot fully measure performance.

In his May 16, 2000, Congressional testimony, the FHA Commissioner claimed the average sales price had increased by more than 13 percent, and the overall recovery as a percent of the mortgage insurance claim increased by nearly 10 percent. This is misleading as an indicator of property disposition operations. The analysis is based on an increase in sales price less the claim payment. Property disposition operations do not have a direct influence on claim amounts. Property disposition program operations should be evaluated based on the percent of appraised value returned on sales less program operating expenses.

Finding 1

Appraised values are determined by independent appraisers that are approved by FHA. Appraised values are driven by real estate market forces including comparable property sales, thus they provide the best benchmark for evaluating program success and comparing performance between various periods.

We compared performance based on SAMS data for the 12 months ended May 31, 2000, after outsourcing to the 12 months ended February 28, 1999, prior to outsourcing. FHA had some successes. For example, we found that sales volume increased about 13 percent. Also the number of properties in inventory declined about 7 percent from 42,272 to 39,330.

However, performance also declined in several critical areas. Sales to owner occupants declined from 57 percent of sales in February 1999 to 53 percent in May 2000. Also, the average loss per property sold increased 30 percent. This occurred because sales price as a percent of appraised value declined and operating expenses increased.

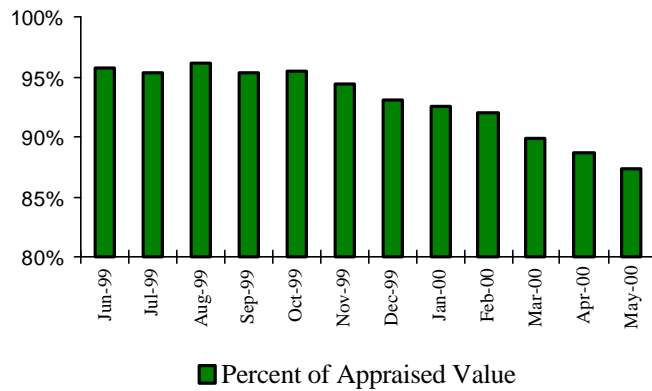
Sales prices as a percent of appraised value declined

FHA claims outsourcing to be a success because the average sales price has increased. This is misleading. Although sales prices have increased, they have not kept pace with the increase in average appraised values. From June 1, 1999, to May 31, 2000,⁴ average sales prices increased 12.5 percent from the prices FHA achieved during the 12 months prior to outsourcing. However, average appraised values of sold properties increased 14.7 percent for the period.

⁴ The first two months of M&M contractor operations were considered start up periods, thus we excluded them from our analysis to present a fair representation of the data.

For the 12 months ending March 31, 1999, FHA staff sold properties on average at 94.5 percent of appraised value. From June 1, 1999, to May 31, 2000, M&M contractors averaged a return of only 92.6 percent. This was attributable somewhat to FHA having revised procedures to allow M&M contractors to reduce property prices to dispose of older inventory more quickly beginning February 28, 2000. However, as the following chart shows, contractors' returns as a percent of appraised values were beginning to decline significantly even before the revised procedures were implemented. The decline is also attributable somewhat to discounted sales programs such as the Officer Next Door Program and sales to non profit organizations. However, the increased sales volume under these programs was minimal, thus the effect on the return was minimal. For the 12 months ended May 31, 2000, a 1 percent decline in percent of appraised value recovered represented a \$56 million loss to the fund. The resulting losses from the decline in the percent of return were \$103 million.

Average Return of Appraised Value



Increased program costs of \$85 million

Maintenance and Operating (M&O) expenses have historically represented about one-third of the expenses associated with single family operations. M&O expenses include M&M contractor fees and monitoring contractor costs. Other expense categories include repairs, taxes, and selling expenses.

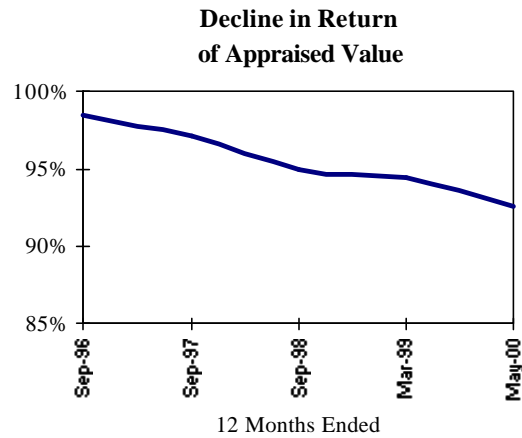
Our analysis showed that while other expense categories remained fairly stable (increasing only 5 percent), M&O expenses increased 51 percent. For over 2½ years prior to outsourcing, M&O expenses increased a total of 21 percent, an annual increase of only 8.5 percent. Since other expenses remained fairly stable and M&O expenses increased only marginally over the prior 2½ years, the recent increase is attributable largely to the costs of outsourcing, i.e., contractor costs.

M&O expenses averaged \$3,051 per property sold for the 12 months prior to outsourcing operations. For the 12 months ending May 31, 2000, the average M&O expense was \$4,615. If M&O expenses increased at the same 8.5 percent rate as in recent years, the expected M&O expenses should have been about \$3,310 per property sold if operations had not been outsourced. Thus, we attribute \$1,305 (\$4,615 - 3,310) of the increase to the costs of outsourcing. Given that FHA sold 77,772 properties for the period, the additional M&O expense resulted in about \$101 million (77,772 x \$1,305) of increased program costs. In addition, FHA was able to reduce the number of full time equivalent program staff from 420 to 168. This resulted in a cost savings of about \$16 million for the period. In total, outsourcing resulted in increased program costs of \$85 million (\$101 million - \$16 million).

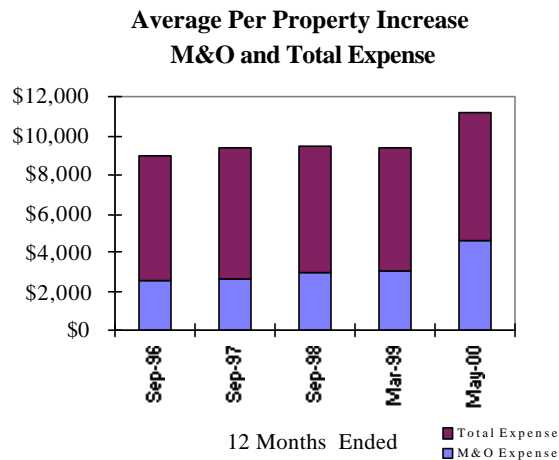
Illustration of returns and expenses since HUD's reorganization

The previous analyses are based on comparisons between contractor operations and the last 12 months of FHA operations prior to outsourcing. FHA was undergoing significant changes during this transition period, and its performance was less than it had historically achieved. Thus, the analyses do not provide the best benchmark for comparing contractor operations to prior operations. For example, when compared to the percent return on appraised value that FHA obtained prior to reorganization, the contractors' performance is extremely poor. For fiscal year 1996, FHA obtained a 98.5 percent return on appraised value. Had the contractors obtained this rate, FHA could have returned an additional \$325 million to the insurance fund.

As shown in the following chart HUD's reorganization has significantly impacted FHA's return on appraised values. The returns have steadily declined since reorganization began. This is particularly disturbing given the healthy economy.



Also, although the average per property M&O and total expenses exhibited moderate annual increases from October 1, 1995, through March 31, 1999, as depicted by the following chart, these expenses increased dramatically in the first year of M&M operations.



FHA needs to establish performance benchmarks

The Office of Management and Budget (OMB) Circular A-76 provides policy guidance and implementing procedures for government agencies to use in deciding whether to contract out for commercial activities. Circular A-76 is a tool federal managers can employ to make sound business decisions and to enhance federal performance through competition and choice. Rather than performing the analysis, the Department obtained a determination from the Chief Financial Officer that a study was not technically required since the new contracting would not affect the jobs of more than 10 employees.

OIG questioned this rationale. In our September 30, 1999, Follow-Up Review of HUD Contracting, we recommended the Department conduct A-76 cost benefit studies when significant spending decisions are evaluated. In her testimony in November 1999, the Assistant Inspector General for Audit said:

“In our opinion, these multi-billion dollar spending decisions are exactly the type of decisions that were envisioned in OMB Circular A-76 and prudent management would encourage careful analysis of such matters. ...the Circular is designed to balance the interest of the parties in a make or buy cost comparison; provide a level playing field between public and private offerors to competition; and encourage competition and choice in the management and performance of commercial activities.”

On September 6, 2000, the Department agreed to perform an analysis that objectively evaluates the cost efficiency of contracting out in-house functions before awarding a contract.

As shown, the first year of outsourcing property disposition activities resulted in increased losses of \$188 million. While we recognize it is no longer feasible to perform an A-76 study, we recommend FHA establish performance benchmarks and develop methods to identify when the costs of outsourcing exceed the benefits obtained. For example, FHA should establish performance benchmarks and critical success factors that are based on recognized industry standards. At a minimum, the measurements should include sales price as a percent of market value, sales price as a percent of claim amount, costs as a percent of sales prices and market value, and percent of properties in inventory over 6 months. It should monitor performance and take

appropriate actions when performance does not meet the established benchmarks.

FHA comments

FHA disagreed with our conclusion regarding revenue losses and additional expenses due to outsourcing. FHA stated, “Recoveries to the MMI fund on claims during the period covered by this audit increased by \$259 million. Recoveries on claims measures in actual dollars the relationship between what FHA paid for a property, and what it sold that property for.” It categorized our methodology as “flawed” and stated that, “This amount was calculated based on a combination of gross return on appraised value, and expenses for property disposition aside from HUD staffing costs. This approach, which is not recognized as a valid basis to account for property sales losses by any organization in the private or public sector, fails to recognize variances in the Housing market across the country, the impact of FHA’s success in selling its aged portfolio, the value of investing in management and marketing expenses to improve returns, and the increased use of community reinvestment opportunities such as the Department’s “Good Neighbor Program.”

Although FHA acknowledged returns based on appraised values have fallen, it claimed this was a temporary situation, “Sales of FHA’s aged portfolio have driven this temporary decline; however, the sale of this aged portfolio represents a singular accomplishment spanning the second half of Fiscal Year 2000.” FHA also stated that increases in discounted sales under the teacher next door, officer next door and non-profit organizations “exacerbates the misleading nature of OIG’s chosen measure.”

Instead of performing an A-76 study, FHA stated, “...a highly successful two-year pilot program was conducted by FHA, in close cooperation with the Office of the Inspector General. The costs and benefits evidenced in that pilot demonstrated the effectiveness of the M&M approach, benefits which are now being realized on a national scale.”

OIG response to
comments

FHA's attempt to discredit sales price as a percent of appraised value as a performance measure is puzzling. This calculation has long been a performance measure used by FHA to measure performance. During 1996 FHA staff teamed with Andersen Consulting to redefine the property disposition program mission and develop measures of program performance. One of the key performance indicators developed from this effort was "Sales Price as a Percentage of Market Value." The Andersen Consulting report states, "The Critical Success Factors, Key Performance Indicators, and metrics defined in this report are measures used by industry, not government, as private REO enterprises generally undertake more and better measurement of performance." During our previous audit of this program FHA Management identified sales price as a percentage of appraised (market) value as their preferred performance measure. Also, return based on appraised value is one of five performance measures tracked on FHA's latest SAMS quarterly report. This report is used by FHA Management to evaluate performance.

FHA now asserts that returns based on cost of claims is the better performance measure. While we agree this method provides useful information, it falls short as a stand alone performance indicator. During strong real estate markets the indicator can mask true performance. In fact, that is what occurred during the first year of outsourcing.

FHA's statement that it recovered an additional \$259 million for the insurance fund based on cost of claims is misleading. The increased revenue is due to increases in sales volume and sales prices. Even though expenses had increased dramatically and returns based on market value declined, sales volume and sales prices increased enough to result in an overall increase in returns to the insurance fund. As stated in the Finding, if FHA had maintained its historical return on appraised value and maintained historical expense levels, it would have returned an additional \$188 million to the fund.

Our draft report did not consider staffing levels in the expense analysis as FHA had not furnished requested information regarding reduced staffing levels. FHA provided this data after the exit conference. We analyzed the data and reduced our estimate of increased expenses accordingly.

Recommendations

We recommend you:

- 1A. Establish performance benchmarks and critical success factors that show when the costs of outsourcing exceed the benefits obtained. This includes, for example, measuring sales prices and costs as percents of market value.
- 1B. Monitor performance and consider alternative program delivery methods when the costs are not justified by the benefits.
- 1C. Revise GPRA goals and reports to include all key performance indicators to provide an accurate assessment of program performance.

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Contractors Did Not Adequately Maintain or Secure Properties

Outsourcing the management of FHA's property inventory has not solved FHA's long standing dilemma of how to adequately protect and preserve these assets. None of the five contractors we audited managed properties according to contract requirements. They did not: (1) perform timely initial inspections, (2) perform adequate inspections, (3) correct hazardous conditions, or (4) make repairs or perform routine maintenance to preserve and protect properties. Of the 189 properties we inspected across the country, 94 percent required some immediate attention. This occurred because the contractors did not have adequate controls to ensure requirements were met, and FHA did not have effective tools to compel them to implement appropriate controls. We also believe that because maintenance and repair costs must be borne by the contractors, contractors have elected not to comply since profits would be reduced. Consequently, the poor property conditions decreased marketability, increased FHA's holding costs, negatively affected surrounding communities, reflected poorly on the Department, and, in some cases, threatened the health and safety of the public. Although FHA has repeatedly reported the deficiencies in its monthly performance assessment reports, property conditions have not improved under private management.

Contract requirements to secure and maintain properties

The M&M contracts require each contractor to perform an initial inspection of newly acquired properties within 24 hours, secure properties to prevent unauthorized entry, protect properties from damage from the elements, remove and properly dispose of all interior and exterior debris, maintain the lawn and shrubbery, properly secure pools and spas, correct any condition that presents a health or safety hazard to the public within 24 hours of discovery, patch roof leaks, and address any other factors which may cause deterioration of condition of the property.

Contractors did not perform timely initial property inspections

FHA assigns about 3,800 properties to the contractors monthly. Initial inspections are required to determine if imminent health or safety hazards exist, personal property remains on the premises, mortgagees conveyed properties in accordance with preservation and protection requirements, and properties are occupied. Our review of property files for 138 active cases found contractors did not inspect 90 properties (65 percent) within 24 hours. Delays ranged from 1 to 43 days. About one third of them were at least 5 days late. This condition was noted for all five contractors under all seven contracts. One contractor did not perform

any initial inspections as required for the 23 properties we tested.

Properties which are not inspected and secured timely are subject to further deterioration and vandalism and potentially reduced return to the insurance fund. Deteriorated and vandalized properties also have negative effects on the surrounding community and reflect poorly on the Department. Failure to perform timely initial inspections slows the overall case processing because property conditions cannot be determined and repairs cannot be made. Delayed inspections also reduce the likelihood of identifying mortgagee neglect.

Contractors did not perform adequate property inspections

Contractors' property inspections did not identify serious property deficiencies. We inspected 189 properties to determine if contractors properly reported property conditions and properly maintained the properties. We compared our inspection results to the most recent contractor inspection reports. We found numerous instances where contractors' reports did not disclose property deficiencies even though the conditions were obvious. The deficiencies included electrical hazards, rotted flooring, missing bathroom fixtures, broken glass, defective paint, water damage, vandalism, inadequate security, and interior and exterior debris. This problem was noted for all five contractors under all seven contracts. One contractor did not disclose readily evident deficiencies in all 27 cases we reviewed.

Following are examples of conditions the contractors' inspectors failed to report.



FHA Case Number 197-041029

Los Angeles, California

Missing sink, vanity and toilet were not reported.



FHA Case Number 048-084891

San Bernardino, California

Extensive vandalism and graffiti.

Contractors did not correct hazardous conditions immediately

Contractors did not correct health and safety hazards within 24 hours as required. Thirty-five percent of the properties we sampled had a hazardous condition. In many cases, the hazards were not, but clearly should have been, identified on the contractors' inspection reports. We found hazards such as missing stair and balcony railings, a porch held up by a broken tree limb, improperly covered swimming pools, rotted porch steps, fire damage, electrical hazards, drug paraphernalia, and dead animals/rodents. One property had

a shotgun under the porch. We noted this problem for all five contractors and six of seven contracts.

In some cases, it appeared these conditions had existed for some time. On December 15, 1999, we inspected the property located at 2992 Chantilly Avenue, Winter Park, Florida. A swimming pool on the property was not properly covered and needed to be drained. Also, the fence around the pool was heavily damaged allowing easy access. There was nothing to prevent children from entering the pool area and falling into the pool. The contractor's November 23, 1999, inspection report showed the pool was unsecured and needed to be drained. The report did not identify the damaged fence. Since the conditions still existed at the time of our inspection, 22 days later, the contractor clearly had not complied with the contract requirement.

The following photographs show examples of hazardous conditions.



FHA Case Number 181-980000

Kansas City, Kansas

Staircase and landing to second floor rotted.



FHA Case Number 412-238835

Cleveland, Ohio

Missing/Broken Steps, Yard Not Maintained



FHA Case Number 094-214300

Sanford, Florida

Tree limbs holding up the porch roof.

Contractors must identify and correct all health and safety hazards within 24 hours to reduce the risk of harm to the public, including risk of severe injury or death and the potential liability to the Department.

Contractors did not make needed repairs or perform routine maintenance

Our property inspections confirmed what FHA reported in its assessment reports. Of the 189 properties we inspected, 94 percent had at least one deficiency that required the contractor's attention. In addition to hazardous conditions, we found the contractors did not make needed repairs or perform routine maintenance to preserve and protect properties. We found defective paint, lawns not maintained, vandalism, roof leaks, unsecured properties, interior and exterior debris, and various other conditions. One contractor did not adequately preserve and maintain any of the 30 properties we inspected.

Appendix A provides a detailed list of the deficiencies by contract area and type of deficiencies found.

The following pictures show examples of the contractor's failure to perform needed repairs and routine maintenance.



FHA Case Number 131-852341

Chicago, Illinois

Lack of lawn maintenance



FHA Case Number 412-237212

Cleveland, Ohio

Debris Under Front Porch



FHA Case Number 372-240835

Buffalo, New York

Property appearance adversely impacts surrounding neighborhood.

Contractors did not have adequate controls

Generally, the contractors hired subcontractors to perform the property inspections, and they performed quality control reviews to evaluate the work of the subcontractors. As evidenced by our property inspections, none of the contractors' quality control techniques were enough to ensure properties were properly inspected, maintained, and secured.

Compliance is not in the contractors' best interests

In its response to GAO, FHA claimed that because the contractors are paid a percentage of the sales price, they have strong financial incentives to properly maintain and promptly sell all properties for the full market value. Under the current contracts and with the condition of much of the current inventory, this is simply not the case. Contractors have strong incentives to make as much money as possible and they will use strategies to ensure they do so. Contractors inevitably will not make repairs or perform routine maintenance unless the costs will be reimbursed by FHA or recovered through increased sales prices. We do not believe the contractors can consistently recover these costs through increased sales prices.

The following hypothetical example shows economic reality from the contractors' perspective of how a contractor would have to sell a property at a higher price in order to recover its repair and maintenance costs. For the example, the appraised value, the initial list price, and the accepted bid are \$100,000. The contractor's fee is 5 percent of the sales price, or \$5,000.

Fee (\$100,000 x 5 percent)	\$ 5,000
Less needed repairs/maintenance costs	<u>- 500</u>
Net fee	\$ <u>4,500</u>

If the contractor spent \$500 to repair or maintain the property, it would realize \$4,500. To recover the \$500, it would have to sell the property for \$110,000 [(\$110,000 sales price x 5 percent fee)-\$500 repair/maintenance cost]. Conversely, the contractor could forego the repairs/maintenance, sell the property for \$90,000 and still realize a net fee of \$4,500. Since the contractors are profit motivated entities, they are not likely to make needed repairs or perform maintenance when it

History of maintenance problems and failed attempts at enforcement

is unlikely they can recover the costs. Thus, the contractors will not be motivated to make the repairs or perform routine maintenance unless FHA makes it financially rewarding to do so.

All 42 FHA assessment reports we reviewed showed contractors failing to comply with property maintenance and security requirements. Although FHA repeatedly documented the poor performance, it had not taken effective corrective action. Although it eventually terminated its contracts with InTown, FHA continued to allow the other contractors to disregard property maintenance and security requirements. This was due in part to its inability to take enforcement actions and lack of available enforcement tools.

FHA issued Letters of Concern to two contractors and Notifications of Deficient Performance to two contractors reflecting the Department's "serious concerns" with their inadequate progress to maintain properties and performance "far below expectations." Nevertheless, performance continued to be unacceptable for all four. As GAO reported, besides issuing letters of concern or deficiency, FHA has no other remedy short of terminating contracts. The former is harmless; the latter is a last resort. FHA does not have other tools available to address deficiencies.

FHA claimed its property maintenance problems were isolated. In its May 2, 2000, response to GAO, FHA said, "Although HUD field staff have identified some specific isolated geographic areas where maintenance has not met HUD's standards, the M&M contractors (with the exception of InTown Management Group) have demonstrated the ability to quickly implement corrective actions and address these deficiencies in response to HUD's assessments." FHA's monthly assessment reports did not support this claim, instead they showed problems with properties throughout the country. Although contractors tended to correct the deficiencies cited in reports, they did not correct systemic problems. This was evidenced both by FHA's continuous reporting of the problems and our property inspections in 13 cities across the country.

Recent testimony by the FHA Commissioner clearly reflects the Department's differing views on the success of the M&M contracts, especially in this area of management of the properties. While FHA concludes that problems are

isolated, we and GAO have found the problems to be much more widespread and systemic. This most recent audit has confirmed to us that the recommendations we made to FHA in our report dated September 17, 1999, are still necessary. Unfortunately, FHA is behind schedule in completing promised action to implement them. Furthermore, as recently as June 2000, FHA negotiated and awarded two new M&M contracts, both without any provisions for monetary sanctions. FHA continues to be unconvinced of the need for penalties and sanctions in its contracts, despite having been advised to do so by three independent audit organizations.

FHA Comments

FHA stated, "Property conditions remain a serious concern for FHA, and performance shortcomings in this area by M&M contractors will not be tolerated." It further stated, "A detailed review of M&M contractor performance prior to a decision on exercising the up-coming option year of most contracts is now underway, and M&M contractors have been advised of this review."

OIG response to comments

We believe its efforts to perform detailed reviews of contractor performance prior to exercising contract options should be a valuable tool if it objectively analyzes performance and makes sound decisions based on the review results. FHA must ensure that it enforces contractor compliance with property maintenance requirements.

Recommendations

We recommend you:

- 2A. Do not exercise options for those contractors who have proven unable or unwilling to comply with critical contract provisions to maintain properties.

- 2B. Devise a system, to be used with all new contracts written, to penalize contractors who fail to perform critical contract requirements. Penalties should be assessed for each instance of non-compliance discovered by FHA, FHA's monitoring contractors, OIG or GAO. The penalties should be set at slightly

above what it would otherwise have cost the contractor to have complied, and to be offset against the contractors' monthly invoices. The system should also include provisions to reward contractors for excellent performance.

- 2C. Consider revising monitoring policies and procedures to permit quarterly reviews and reduced sample sizes when justified by prior reviews in order to focus on areas of concern such as property maintenance and security.

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Contractors Violated Other Contract Requirements

The contractors failed to adhere to several other contract requirements. They did not obtain timely property appraisals, approve disposition programs timely, or properly review HUD-1, Settlement Statements. We also found isolated instances of other contract violations. This occurred because FHA did not enforce compliance and the contractors did not have adequate controls to ensure compliance. The noncompliance could significantly increase the risk of loss to the insurance fund.

Contractors did not obtain property appraisals timely

Contractors are required to obtain an appraisal within 10 business days of assignment. Our review of 137 applicable cases showed the contractors did not meet the 10-day requirement for almost half (59) of the cases. The delays ranged from 1 to 66 days. Thirty-two of the 59 late appraisals were 5 or more days late. We found this problem with all five contractors and all seven contracts. One contractor did not meet the 10-day requirement for 11 of the 15 cases we reviewed.

Contractors cannot list properties for sale without an appraisal. Delayed listings may result in delayed sales, increased holding costs, and reduced return to the insurance fund.

Contractors did not approve disposition programs timely

The contractors were required to review and approve disposition programs within 3 business days of receipt of the appraisal. The disposition program establishes the list price and the manner and terms under which each property will be offered for sale. Properties should not be listed for sale without an approved disposition program. For 46 of the 127, 36 percent, applicable cases reviewed, the disposition programs were not approved as required. We found at least one deficiency for all five contractors under all seven contracts. Delays ranged from 1 to 68 days. Twenty-five of the 46 were approved 5 or more days late. One contractor did not meet the 3-day requirement for 13 of 18 cases we reviewed. Delays in preparing and approving the programs cause properties to remain in inventory longer, thus increasing costs and reducing the return to the insurance

Contractors did not review HUD-1 settlement statements

fund. One contractor was not aware of the 3-day requirement.

Contractors are given specific instructions on reviewing the form HUD-1 Settlement Statement to ensure only eligible expenses are charged to FHA and the form is accurately completed. The contracts specifically require the contractors to review, correct and certify the closing documents within 5 days after receipt.

Forty-eight of 116 closed cases we reviewed did not show evidence of contractor review of the HUD-1. We noted this problem for four of the contractors and five of the seven contracts. One contractor admitted it did not review the forms believing it was the closing agents' responsibility.

Although our review did not identify significant discrepancies, the risk to FHA and the insurance fund is increased because of the contractors' failure to perform the reviews. Considering the contractors sold an average of about 4,270 homes a month during the audit period, the risk could be significant.

Other contract compliance problems

Although less frequently, we found instances of contractors' failure to: take appropriate steps to resolve title and other problems concerning Held Off Market properties (2 contractors); timely review and approve or reject title evidence (2 contractors); timely reconcile sales proceeds (1 contractor); document proper review of Mortgagee Claim form HUD-27011 (2 contractors); and notify FHA of mortgagee neglect and closing agent problems (1 contractor).

Each of the procedures is important to the successful accomplishment of the program mission. Furthermore, the contractors have a legal obligation to perform, as provided in return for the fee they receive upon the listing and sale of each property.

FHA Comments

FHA generally agreed with the finding and stated, "FHA is acquiring more refined file review contract services, expected to be in place by the second quarter of FY 2001.

...FHA is currently conducting a detailed analysis of contractor performance prior to decisions on exercising option years in the current contracts.”

OIG response to
comments

We agree that FHA should analyze contractor performance prior to making decisions on exercising options. It must perform an objective analysis and make sound decisions based on the review results. Also, FHA must appropriately sanction contractors who do not comply with contract requirements.

Recommendations

We recommend you:

- 3A. Sanction contractors who do not comply with contract requirements.
- 3B. Do not exercise options for those contractors who have proven unable or unwilling to comply with critical contract provisions.

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Follow-Up on Prior Audits

Several prior audit reports contain findings which impact the objectives of this audit.

- An OIG audit (Report Number 99-AT-123-0001, dated September 1999) of FHA's Single Family Property Disposition Program concluded that:
 - FHA's reorganization adversely affected the program mission.
 - FHA incurred millions in unnecessary holding costs and revenue losses.
 - FHA's controls over M&M contracts needed strengthening.

To address these concerns, the report made several recommendations to strengthen FHA's M&M management control manual. These recommendations included: (1) issuing detailed written policies and procedures for approving reimbursement and documenting the need for repairs associated with natural disasters, extraordinary vandalism, etc.; (2) providing policies and procedures detailing how often risk assessments must be made for critical events and providing standard documents for completing the overall risk assessment and for completing the monthly final report; (3) developing a system to track and summarize monitoring results to identify trends and systemic weaknesses for corrective action; and (4) modify the M&M contracts to require monetary penalties (e.g., liquidated damages) for specific recurring contract deficiencies.

- A General Accounting Office (GAO) audit (Report Number GAO/RCED-00-117, dated May 2000) of FHA's Single-Family Housing Disposition Program concluded that:
 - HUD has limited contractor incentives or tools available to enforce contractor compliance. Although HUD effectively identified performance problems, it did not effectively correct them.
 - Inconsistencies in the HOC's development and reporting of contractor assessments reduced the usefulness of the assessments for tracking and comparing performance.

GAO recommended that FHA develop more effective methods, such as specific incentives or penalties, to encourage contractors to reduce the number of properties in inventory longer than six months.

- A 1999 audit of FHA's financial statements performed by KPMG, LLP found property maintenance deficiencies and processing delays.

The report recommended that FHA devise a method of penalizing contractors that routinely do not comply with performance requirements.

FHA and OIG have agreed on a series of corrective actions which, if implemented, should be adequate to resolve the above concerns.

As discussed in the “Findings and Recommendations” section of this audit report, many of these previously reported conditions still exist. These include unnecessary revenue losses, limited enforcement tools to enforce contractor compliance, property maintenance deficiencies, and processing delays. Also, controls over M&M contractors still need strengthening. Although our report addresses other related concerns, we believe the recommendations made by HUD OIG, GAO, and KPMG, LLP remain valid, and their resolution is essential to the ultimate improvement and success of FHA’s Single-Family Disposition Program.

Results of OIG Property Inspections

Percent of Properties With Deficiencies

Area	Defective Paint	Lawn Not Maintained	Vandalism	Roof Leaks	Unsecured	Debris	Hazards
A1	54	62	27	42	31	50	54
A3	9	12	26	30	0	52	39
D3	54	15	35	58	42	35	42
P1	89	71	25	11	55	30	20
P2	74	52	70	37	31	44	70
P3	78	52	22	37	89	22	19
C1	53	47	37	37	30	20	83

OIG Inspections Performed

Contractor	Area	Property Locations	Number of Properties Inspected
Golden Feather Realty	A1	Chicago, Illinois	12
		Indianapolis, Indiana	14
Southeast Alliance	A3	Orlando, Florida	23
First Preston	D3	New Orleans, Louisiana	16
		Kansas City, Missouri	10
CitiWest New England	P1	New Haven, Connecticut	15
		Waterbury, Connecticut	15
Michaelson	P2	Cleveland, Ohio	15
		Detroit, Michigan	12
First Preston	P3	Philadelphia, Pennsylvania	13
		Buffalo, New York.	14
Golden Feather Realty	C1	Los Angeles, California	15
		San Bernardino, California	15
Total Inspections			189

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FHA Comments

September 15, 2000

MEMORANDUM FOR: Nancy H. Cooper, District Inspector General for Audit, 4AGA

FROM: William C. Apgar, Assistant Secretary for Housing- Federal Housing Commissioner, H

SUBJECT: FHA Response to OIG Nationwide Internal Audit of FHA's Single Family Property Disposition Program

Thank you for the opportunity to review and comment on your audit report on the Single Family Property Disposition program. This audit assesses program activities from April 1999 through March 2000, representing the First 12 months of operating HUD's property disposition program under its Management and Marketing (M&M) Contract structure. On March 29, 1999 FHA implemented these contracts, which are the cornerstone of the HUD 2020 reform plan for single family property disposition. While I am pleased that your Office has corrected a number of misrepresentations included in your September 19, 1999 audit of this same program, I hope to provide important clarifications which will enable you to adjust your draft report before it is finalized.

As noted in the executive summary, this report incorporates results from seven other OIG audits of this program conducted over the past several months. While several additional audits have not yet been completed, it is my understanding that you do not expect these other audits to result in additional findings and recommendations. This draft report correctly notes that through its M&M contracts FHA has substantially reduced its inventory of HUD-held properties. In fact, FHA's inventory has now been reduced by 18,000 properties, a 34 percent reduction in inventory in a period of little over one year. To contrast this with an earlier cycle in the Housing market, in 1989 FHA's inventory of HUD-held homes reached 54,000. It required FHA two and one half years to achieve a similar reduction in its inventory. Most significantly, and contrary to the findings noted in your draft report, FHA accomplished this feat while increasing recoveries to FHA's Mutual Mortgage Insurance (MMI) Fund, and increasing community reinvestment using HUD homes. The report states that "FHA's failure to perform a cost-benefit analysis in accordance with A-76 contributed to an unnecessary loss of funds." As supported in FHA's audited financial records, FHA's "loss rate," that portion of an insurance claim which cannot be recovered through the sale of a property, has been reduced under the Management and Marketing contract environment. Recoveries to the MMI fund on claims during the period covered by this audit increased by \$259 million. Data supporting these recoveries were drawn from the Single Family Asset Management System and provided to OIG staff. Recoveries on claims measures in actual dollars the relationship between what FHA paid for a property, and what it sold that property for. FHA cannot fulfill its fiduciary responsibilities without considering this primary benchmark for financial performance. FHA remains convinced that it is a valid measure of Property Disposition operations as movement in the ratio directly mirrors control over expenses and successful marketing of properties.

A memorandum from the Department's Chief Financial Officer found that an A76 study was not required for the implementation of the M&M contracts. Instead, a highly successful two-year pilot program was conducted by FHA, in close cooperation with the Office of the Inspector General. The costs and benefits evidenced in that pilot demonstrated the effectiveness of the M&M approach, benefits which are now being realized on a national scale.

The primary basis for such startlingly different conclusions on the effectiveness of the M&M program lies in a flawed calculation by OIG staff of program “losses,” summarized by the statement in the Executive Summary that “outsourcing of program operations resulted in reduced returns to the mortgage insurance fund of about \$204 million.” This amount was calculated based on a combination of gross return on appraised value, and expenses for property disposition aside from HUD staffing costs. This approach, which is not recognized as a valid basis to account for property sales losses by any organization in the private or public sector, fails to recognize variances in the Housing market across the country, the impact of FHA’s success in selling its aged portfolio, the value of investing in management and marketing expenses to improve returns, and the increased use of community reinvestment opportunities such as the Department’s “Good Neighbor Program.”

While return on appraised value can be an effective program measure when taken in conjunction with other indicators, it completely lacks the precision required for an effective financial indicator. Drawing conclusions on the cause of fluctuations in prior year comparisons must be done cautiously. Valuation is an art not a science. Two appraisers can differ on their valuation of the same property by more than one percent, without either being wrong. To ascribe the change principally to M&M performance, despite the other factors cited above, is simply not credible.

Over the 12-month period covered by this audit, FHA’s gross sales return to appraised value did begin to decline, from 94.66 percent to 94.59 percent. Net returns on sales as a percentage of appraised value have continued to decline, in recent months, to 92.6 percent. Sales of FHA’s aged portfolio have driven this temporary decline; however, the sale of this aged portfolio represents a singular accomplishment spanning the second half of Fiscal Year 2000. Sales of properties which had been held in inventory over a year increased from 5.8 percent (pre-M&M) to 13.7 percent.

Prior OIG audits were critical of the perceived failure of FHA to more swiftly move its hard-to-sell properties. FHA has in fact cut deeply into the inventory of aged properties. When properties fail to sell swiftly, they are re-evaluated, often using Broker Price Opinions (BPOs) rather than re-appraisals, and list prices are subsequently reduced. BPOs are used by most private sector organizations to price all properties. Since these properties are not re-appraised (a more costly market pricing approach), the increase in sales of aged properties distorts the value of the sales-to-appraised value indicator. To illustrate this point, FHA compared property sales by time in inventory. Excluding sales of properties which had been in inventory more than one year, the difference in sales to appraised value this fiscal year rose from 92.6 percent to 94.3 percent. Further, FHA increased its community reinvestment sales (discounted sales to local governments, non-profit organizations, law enforcement officers, and teachers, for homes located in revitalization areas) from 8.8 percent to 10.4 percent. This increase in discounted sales, designed to help meet public purpose goals, further exacerbates the misleading nature of OIG’s chosen measure.

Property conditions remain a serious concern for FHA, and performance shortcomings in this area by M&M contractors will not be tolerated. However, I take issue with the conclusion in the draft report that “although FHA repeatedly documented the poor performance, it had not taken effective corrective action.” The termination of Intown Management Group in seven of the then 16 contract areas can hardly be considered insignificant. Deficiencies in contractor performance are documented each month on each contractor for each contract area as part of a control process which OIG staff acknowledge represent a vast improvement over pre-M&M practices. Cure notices, a required measure prior to more severe contract sanctions, have been issued for five additional contract areas. Improvements in contractor performance following issuance of these notices have been carefully tracked. A detailed review of M&M contractor performance prior to a decision on exercising the up-coming option year of most contracts is now underway, and M&M contractors have been advised of this review.

The payment to M&M contractors of ineligible costs, no matter how minimal in comparison to the total payments (actual ineligible costs identified in the draft represented .02 percent of total annual management and marketing fees), is a concern to FHA. The use of computer-assisted auditing techniques used by your Office appears to be a promising addition to FHA's arsenal of contract controls, and your support in helping FHA understand this approach, and how it might be employed by FHA staff, would be greatly appreciated.

Despite inconsistencies in many of the findings in this draft report, a number of the recommendations represent reasonable program management initiatives. For example, FHA already conducts detailed quarterly cost-benefit analyses, which have been shared with OIG. FHA is striving to enhance its array of program performance indicators, to better reflect regional market conditions. FHA has added a number of financial controls, including the addition of a third party review of contractor fees and sales proceeds reconciliation. FHA is acquiring more refined file review contract services, expected to be in place by the second quarter of FY 2001. As noted earlier, FHA is currently conducting a detailed analysis of contractor performance prior to decisions on exercising option years in the current contracts. Finally, FHA has undertaken a series of M&M contractor "corporate reviews" to ensure the effectiveness and reliability of subcontracting relationships.

I hope that you will accept the deficiencies in the draft report identified above as constructive criticisms, and my staff will be glad to provide any clarification or additional information required to effect the needed changes. Please refer any questions to Joseph McCloskey, Director, Office of Single Family Asset Management, at 202-708-1672.

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