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| Audit Report Number 2007-PH-0002 |
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TO: Brian D. Montgomery, Assistant Secretary for Housing – Federal Housing
Commissioner, H

FROM:  John P. Buck, Regional Inspector General for Audit, Philadelphia Regional
Office, 3AGA

SUBJECT: HUD's Oversight of Contractors' Marketing of Its Real Estate-Owned
Properties

HIGHLIGHTS

What We Audited and Why

In accordance with our annual audit plan, we initiated an internal audit involving management and marketing contractors (contractors) under the jurisdiction of the U.S. Department of Housing and Urban Development's (HUD) Philadelphia Homeownership Center. The purpose of the audit was to determine whether HUD's oversight of its contractors ensured that the contractors marketed HUD's real estate-owned properties in accordance with their contract requirements.

What We Found

HUD's Philadelphia Homeownership Center's oversight of its contractors did not ensure the effective marketing of HUD's real estate-owned properties. During our review period of August 2004 through September 2006, the Philadelphia Homeownership Center's contractors routinely failed to meet their marketing performance requirements. Marketing performance failed to meet targets because the sales goals and other objectives measured under contract terms were inconsistent with local market conditions and inflexible. Homeownership Center

staff monitored performance monthly, as required, but without overall positive impact on inventory reduction, improved return on sales, or increased owner occupancy of HUD real estate-owned properties. As a result, the Philadelphia Homeownership Center is not fully accomplishing HUD's national goal to expand homeownership opportunities, strengthen neighborhoods and communities, and ensure a maximum net return to the mortgage insurance fund.

What We Recommend

We recommend that the assistant secretary for housing – federal housing commissioner establish and implement procedures to address cases in which contractors demonstrate a pattern of not meeting their contract requirements. We also recommend that the assistant secretary assess HUD's policies discussed in this report and revise them as needed to improve the contractors' performance and, thereby, better accomplish HUD's goals regarding its real estate-owned properties.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided a draft report to the assistant secretary for housing – federal housing commissioner on July 5, 2007. We discussed the report with officials from the Office of Single Family Asset Management on July 23, 2007. Formal written comments to our draft report were received on August 3, 2007. In its response, HUD stated it concurred with the findings of the audit and would prepare an appropriate managerial response upon receipt of the final report. The complete text of the HUD's response can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVES

Management and marketing contractors are responsible for properly maintaining and marketing properties acquired and disposed of through the Federal Housing Administration's (FHA) Single Family Property Disposition program. One of the primary objectives of the program is to ensure that U.S. Department of Housing and Urban Development (HUD)-owned single-family properties are marketed in a way that maximizes net return to the mortgage insurance fund, minimizes holding time, and expands homeownership.

The Philadelphia Homeownership Center is responsible for six active management and marketing contracts with base contracts totaling about \$114 million. Five of the contracts were modified exercising the first two option years, adding approximately \$120 million to the contracts. Therefore, the obligations for the six Philadelphia-based contracts totaled about \$234 million, of which about \$91 million had been expended as of February 2007.

HUD evaluates the marketing performance of each management and marketing contractor by assessing six established critical performance requirements monthly. Each of the six requirements is assessed by computing and comparing the contractors' attained scores to HUD's established minimum satisfactory ratings. These performance requirements are included in HUD's contract with the management and marketing contractors and are used to determine whether the contractors should receive incentives.

Our audit objective was to determine whether HUD's oversight of its management and marketing contractors ensured that the contractors marketed HUD's real estate-owned properties in accordance with their contract requirements.

RESULTS OF AUDIT

Finding: HUD's Controls and Policies Regarding Its Contractors' Marketing Performance Were Inadequate

HUD's Philadelphia Homeownership Center's oversight of its contractors did not ensure the effective marketing of HUD's real estate-owned properties. During our review period of August 2004 through September 2006, the Philadelphia Homeownership Center's contractors routinely failed to meet their marketing performance requirements as illustrated in appendixes B and C. Marketing performance failed to meet targets because the sales goals and other objectives measured under contract terms were inconsistent with local market conditions and inflexible. Homeownership Center staff monitored performance monthly, as required, but without overall positive impact on inventory reduction, improved return on sales, or increased owner occupancy of HUD real estate-owned properties. As a result, the Philadelphia Homeownership Center is not fully accomplishing HUD's national goal to expand homeownership opportunities, strengthen neighborhoods and communities, and ensure a maximum net return to the mortgage insurance fund.

HUD's Oversight of Its Contractors Did Not Ensure the Marketing of Real Estate-Owned Properties in Accordance with Contracts

HUD's oversight of its contractors did not ensure the marketing of HUD's real estate-owned properties in accordance with management and marketing contract performance requirements. HUD reviews Single Family Acquired Asset Management System (SAMS) reports and generates scorecards on the contractors' marketing performance by assessing the following six contract requirements monthly:

- Effectiveness of marketing strategy in producing acceptable net returns,
- Properties sold at market value,
- Properties sold quickly as measured by properties in inventory for more than 365 days,
- Properties sold quickly as measured by average holding time,
- Accuracy of property values, and
- Sales to owner-occupants.

The contractors are required to meet the minimum satisfactory rating established by HUD for each performance requirement. We assessed the performance of five contractors servicing the Philadelphia Homeownership Center from August 2004

through September 2006 by reviewing the HUD-generated scorecards for each contractor from 17 to 20 months.

The contractors routinely failed to meet the marketing performance requirements above as illustrated in appendixes B and C. They performed especially poorly in the areas of minimizing the percentage of inventory older than 365 days, reducing the average holding time for properties, promoting sales to owner-occupants, and ensuring the accuracy of property values. For example, two contractors failed to pass the requirement for properties to sell quickly (as measured by inventory older than 365 days) for the entire review period of 20 months, indicating a 100 percent failure rate. Another contractor failed the requirement 90 percent of the review period. Together, the three contractors failed the requirement for properties to sell quickly as measured by average holding time at least 85 percent of the review period. Also, three contractors failed the requirement to promote sales to owner-occupants in at least 15, or 75 percent, of 20 months reviewed. In addition, two contractors failed to meet the requirement for accurate property values in at least 14, or 70 percent, of 20 months reviewed.

HUD's oversight of its contractors did not ensure the marketing of HUD's real estate-owned properties in accordance with marketing performance requirements during our review period. This noncompliance occurred because HUD did not have sufficient controls and effective policies in place to ensure that contractors met their contract requirements as discussed below.

HUD Did Not Establish and Implement Sufficient Controls to Oversee Its Contractors

HUD did not establish and implement sufficient controls to effectively oversee its contractors. Although HUD staff performed monthly reviews to assess the contractors' marketing performance, they did not perform sufficient follow-up to ensure that noted deficiencies were corrected. HUD staff sent out monthly and quarterly letters of defective performance along with illustrative scorecards to contractors that did not meet performance requirements; however, HUD has no established procedures for addressing cases in which contractors routinely fail to meet performance requirements.

HUD also did not ensure that quality control plans were submitted by each of its contractors as required by their contracts. The required quality control plan is a contractor tool to ensure that the management and marketing contract is followed and performance requirements are met, and that there is a plan for corrective action if deficiencies in performance are identified.

In a conference held in February 2006 between HUD and all of its contractors nationwide, the quality control plans were discussed, and guidance on the related requirements was provided to the contractors. In April 2006, HUD's principal contracting officer stated that few, if any, quality control plans submitted nationwide were adequate. As of May 2007, the Philadelphia Homeownership Center did not have an approved quality control plan for any of its six contractors, and at least three of the contractors had not submitted an acceptable quality control plan since the beginning of their contracts almost three years earlier. HUD had no established controls or procedures to ensure that contractors submit acceptable quality control plans and/or to ensure that action is taken against contractors who do not meet the requirement. For example, in May 2006, the branch chief of the Real Estate Owned division in the Philadelphia Homeownership Center sent an e-mail reminding a specific contractor that it did not have an approved quality control plan and that it never had. The contractor submitted a revised quality control plan in August 2006, which was rejected by HUD in September 2006. As of May 2007, eight months later, no updated quality control plan had been submitted, and no action had been taken against the contractor.

HUD Should Evaluate Its Repair Threshold for Providing Insurance on Its Properties

According to HUD Handbook 4310.5, HUD's general policy is for properties to be sold on an "as is" basis without repairs. HUD's financing programs for disposing of its inventory of properties are as follows: (1) Insured, if the property in its present condition meets the intent of HUD's minimum property standards; (2) Insured with Repair Escrow, if the property needs less than \$5,000 worth of repairs to meet the intent of HUD's minimum property standards; (3) Section 203(k), which allows a buyer to obtain one mortgage loan to finance acquisition and repair of a property, provided the repairs required make financing feasible; and (4) Uninsured, if the property in its present condition fails to meet the requirements for the first three financing programs. In short, the HUD guidance indicates that a property is uninsurable if it needs more than \$5,000 worth of repairs to meet the intent of HUD's minimum property standards. HUD Handbook 4310.5 was last revised in May 1994; therefore, HUD has not assessed the feasibility of the \$5,000 threshold or adjusted it for inflation or other factors that may be relevant in more than a decade.

For the Philadelphia Homeownership Center, about 54 percent of all properties listed at the end of November 2006 were uninsurable. This means that more than half of the properties required repairs exceeding the \$5,000 threshold. Contractors stated that properties are more appealing to both owner-occupant buyers and lenders if they are offered for sale with insurance. HUD should assess the feasibility of the \$5,000 threshold and adjust it as appropriate so that more of

its properties can be sold insured. Doing so would allow HUD to better accomplish its mission of promoting sales to owner-occupants and, thereby, increase homeownership.

HUD's Marketing Incentives Might Not Be Attainable

HUD's marketing incentives for its contractors appear to be unattainable. According to the management and marketing contracts, contractors can only earn marketing incentives if they meet or exceed HUD's established minimum satisfactory ratings for all of the following four performance requirements during a performance quarter: effectiveness of marketing strategy in producing acceptable net returns, properties sold quickly as measured by properties in inventory for more than 365 days, properties sold quickly as measured by average holding time, and sales to owner-occupants. However, the contractors generally did not meet the minimum satisfactory ratings required to demonstrate their success at meeting the performance requirements, and as a result, did not earn any marketing incentives. To date, none of the contractors has earned a marketing incentive because the contractors have not been able to meet all four of the performance requirements for any given performance quarter.

One contractor stated that they would never make the minimum satisfactory rating for the "sales to owner-occupants" requirement because while the minimum satisfactory rating increases each year, its properties generally did not appeal to owner-occupants because they required a lot of repair. The current downturn in the housing market has also probably impacted the contractors' ability to meet HUD's established minimum satisfactory ratings for their performance requirements. According to a CNN Money article, dated April 24, 2007, home sales have experienced the worst drop in 18 years.

HUD's marketing incentives are only meaningful to the extent that they motivate contractors to improve or put forth their best performance. The marketing incentives will not motivate the contractors if they are not attainable. HUD should assess the validity of its established minimum satisfactory ratings for each contractor based on market conditions, the contractor's unique challenges, and other relevant factors to determine whether revisions are needed. HUD should also consider prorating its marketing incentives so that contractors receive a portion of the total available incentive if they meet the minimum satisfactory ratings for any of the four performance requirements listed above. Doing so will make the marketing incentives more attainable and, thereby, more meaningful.

The Philadelphia Homeownership Center Needs to Improve Its Procedure for Ensuring the Accuracy of Contractors' Property Values

In accordance with HUD's Management and Marketing Contractor Quality Assurance Plan, the Philadelphia Homeownership Center retains a contractor to review 10 percent of appraisals performed on newly acquired properties each month. The review is performed to ensure that contractors' property values are accurate. The monthly 10 percent sample is selected based on the total acquired properties for the entire Homeownership Center. Since some contractors do not have as many acquired properties as others, their appraisals are sometimes either not reflected or minimally represented in the sample.

During our review of the assessment forms used to determine whether contractors' property values were accurate, we found that some of the contractors had relatively few or no reviews performed during certain months. The scorecards for one of those contractors indicated that the contractor had problems in meeting the requirement for accurate property values. It is important for the Philadelphia Homeownership Center to implement effective controls to ensure that property values are generally accurate for all of the contractors. For example, HUD staff could select 10 percent or the minimum percentage possible of the appraisals for each contractor to ensure that it reviews a more representative sample of the total population of appraisals. Without implementing an effective method or procedure to ensure that it consistently reviews a representative sample of appraisals for all of its contractors, the Philadelphia Homeownership Center has no reasonable assurance that its contractors' property values are generally accurate.

Conclusion

Our review of the Philadelphia Homeownership Center disclosed that HUD's oversight of its management and marketing contractors did not ensure the marketing of HUD's real estate-owned properties in accordance with marketing performance requirements during our review period. The Philadelphia Homeownership Center's management and marketing contractors routinely failed to meet their marketing performance requirements as illustrated in appendixes B and C. HUD did not establish and implement sufficient controls or procedures to ensure that contract requirements were met. Also, HUD's policy for qualifying properties to be offered for sale with insurance is outdated and might not have allowed contractors to obtain optimal marketing performance results. In addition, HUD's policy for awarding marketing incentives to its contractors should be assessed and revised if feasible because the incentives appear to be unattainable.

Because the management and marketing contractors did not meet performance requirements established to ensure that HUD's real estate-owned properties are marketed in a way that maximizes net return to the FHA mortgage insurance fund, minimizes holding time, and expands homeownership, HUD is not fully accomplishing its goal of reducing its inventory of real estate-owned properties in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum net return to the mortgage insurance fund.

Recommendations

We recommend that the assistant secretary for housing – federal housing commissioner

- 1A. Establish procedures to address cases in which contractors demonstrate a pattern of not meeting the requirements stated in their contracts.
- 1B. Assess the \$5,000 threshold for uninsurable properties and adjust it as appropriate so that more properties can qualify for FHA insurance.
- 1C. Assess the validity of contractors' current minimum satisfactory ratings for their marketing performance requirements based on market conditions and contractors' unique challenges to determine whether revisions are needed.
- 1D. Evaluate HUD's policy for awarding marketing incentives and consider awarding the incentives to contractors on a prorated basis if feasible.
- 1E. Direct the Philadelphia Homeownership Center to establish and implement a more effective method of ensuring that its contractors' property values are generally accurate.

SCOPE AND METHODOLOGY

To accomplish our objectives, we performed the following:

- Reviewed HUD's processes and controls in effect to ensure management and marketing contractors' compliance with marketing performance requirements.
- Reviewed data and forms used to assess contractors' marketing performance, as well as scorecards generated from assessment forms.
- Reviewed contracts and other documents pertaining to the marketing function of the contractors.
- Reviewed applicable HUD handbooks, mortgagee letter, and news articles.
- Conducted interviews with Philadelphia Homeownership Center and HUD headquarters personnel.
- Conducted interviews with two Philadelphia Homeownership-based management and marketing contractors and their appraisers and listing brokers.

In addition, we relied in part on computer-processed data from HUD's Single Family Data Warehouse as well as the Single Family Acquired Asset Management System. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data adequately reliable for our purposes.

The audit generally covered the period from August 1, 2004, through September 30, 2006. We expanded the audit period as necessary to properly complete our reviews. We conducted our fieldwork from November 2006 through June 2007.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- HUD's procedures for overseeing its management and marketing contractors to ensure that the contractors market HUD properties in accordance with their contract requirements.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- HUD lacked sufficient controls and effective policies to ensure that management and marketing contractors complied with their marketing performance requirements.

APPENDIXES

Appendix A

AUDITEE COMMENTS

Auditee Comments

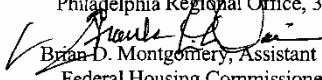


U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

AUG - 3 2007

MEMORANDUM FOR: John P. Buck, Regional Inspector General for Audit,
Philadelphia Regional Office, 3AGA

FROM: 
Brian D. Montgomery, Assistant Secretary for Housing-
Federal Housing Commissioner, H

SUBJECT: Response to the Inspector General's (IG) Draft Internal Audit
Report on HUD's Oversight of Single Family Management
and Marketing (M&M) Contractors Under the Jurisdiction of
the Philadelphia Homeownership Center

Single Family Housing has reviewed the Inspector General's (IG) draft internal audit report of HUD's oversight of M&M contractors under the jurisdiction of the Philadelphia Homeownership Center. Single Family Housing concurs with the findings of the audit and will prepare an appropriate managerial response upon receipt of the final audit.

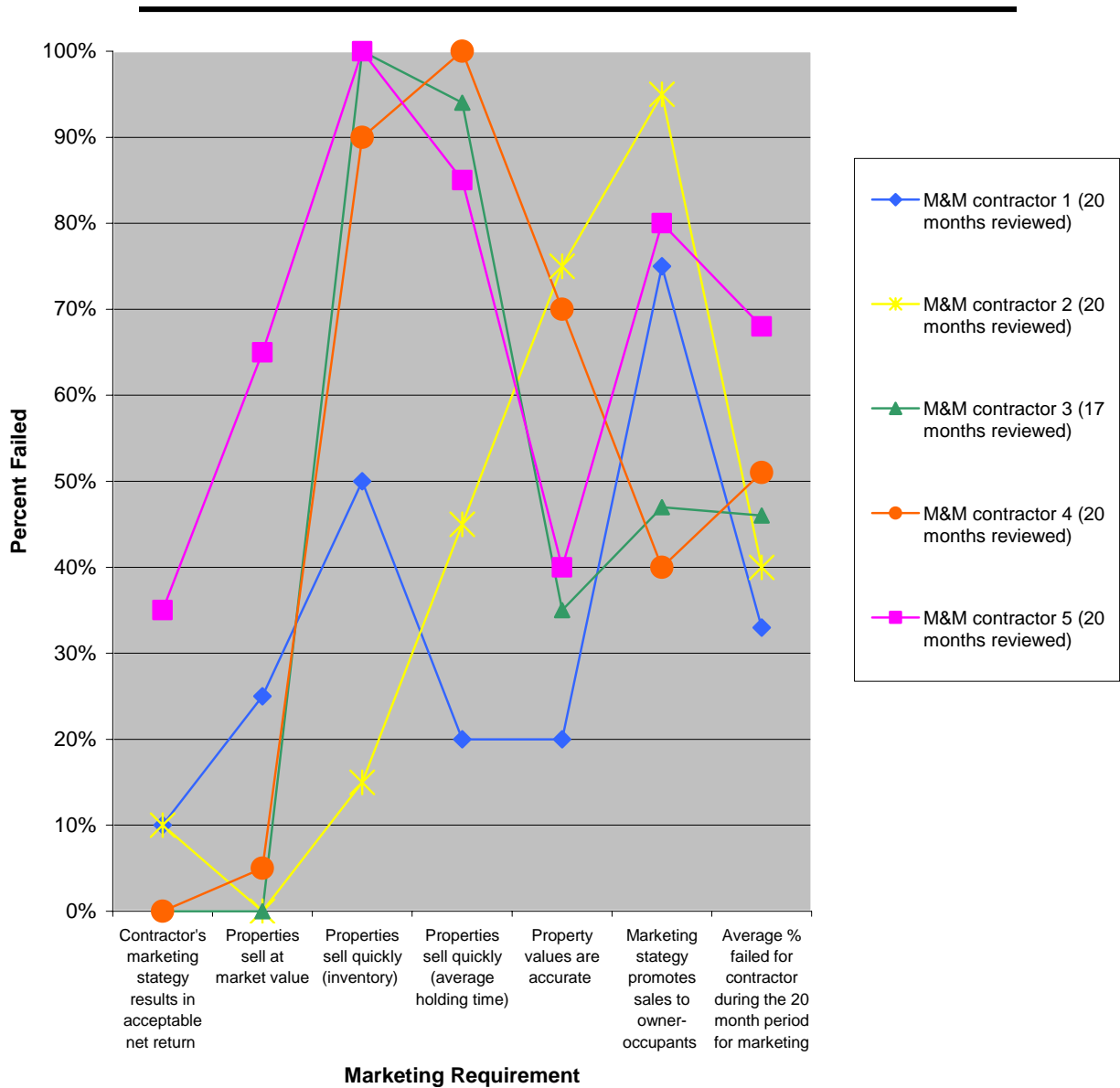
If you have any additional questions please contact Vance T. Morris, Director, Office of Single Family Asset Management on 202-708-1672, extension 2419.

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Appendix B

GRAPHED SUMMARY OF CONTRACTORS' MARKETING PERFORMANCE



Note: "M&M" stands for "management and marketing."

Appendix C

TABULATED SUMMARY OF CONTRACTORS' MARKETING PERFORMANCE

| Marketing requirement | | Contractor 1 (20 months reviewed) | Contractor 2 (20 months reviewed) | Contractor 3 (17 months reviewed) | Contractor 4 (20 months reviewed) | Contractor 5 (20 months reviewed) | Average % failed for each requirement |
|--|----------|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|---------------------------------------|
| Contractor's marketing strategy results in acceptable net return | Failed | 2 | 2 | 0 | 0 | 7 | 11% |
| | % failed | 10% | 10% | 0% | 0% | 35% | |
| Properties sell at market value | Failed | 5 | 0 | 0 | 1 | 13 | 19% |
| | % failed | 25% | 0% | 0% | 5% | 65% | |
| Properties sell quickly (inventory) | Failed | 10 | 3 | 17 | 18 | 20 | 71% |
| | % failed | 50% | 15% | 100% | 90% | 100% | |
| Properties sell quickly (average holding time) | Failed | 4 | 9 | 16 | 20 | 17 | 69% |
| | % failed | 20% | 45% | 94% | 100% | 85% | |
| Property values are accurate | Failed | 4 | 15 | 6 | 14 | 8 | 48% |
| | % failed | 20% | 75% | 35% | 70% | 40% | |
| Marketing strategy promotes sales to owner - occupants | Failed | 15 | 19 | 8 | 8 | 16 | 67% |
| | % failed | 75% | 95% | 47% | 40% | 80% | |