



Issue Date	November 5, 2001
Audit Case Number	2002-SF-0001

TO: Frederick Douglas
Deputy Assistant Secretary for Single Family Housing, HU

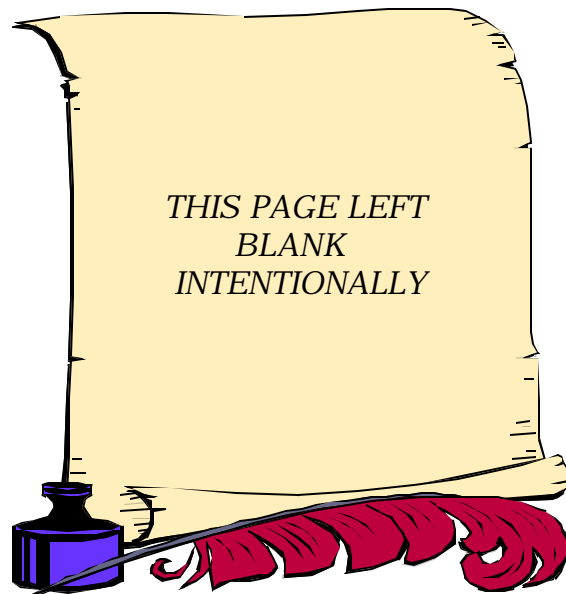
//SIGNED//
FROM: Mimi Y. Lee
District Inspector General for Audit, 9AGA

SUBJECT: Nonprofit Participation in HUD Single Family Programs

We completed a nationwide audit of nonprofit participation in HUD single family programs, with an emphasis on HUD's discount sales program. This report contains two findings with recommendations for improving single family operations and requiring action by your office.

Within 60 days please give us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact Charles Johnson, Senior Auditor, at (602) 379-4681, or myself at (415) 436-8101.



Executive Summary

We have completed an audit of nonprofit organizations' participation in Federal Housing Administration (FHA) insured single family programs. The primary objectives of our review were to determine whether (1) current approval and monitoring policies, procedures, and guidelines are adequate to ensure nonprofit organizations participating in the discount sales program are legitimate, independent organizations; (2) financial benefits resulting from discounted sales prices are passed on to low and moderate income homebuyers; (3) revitalization areas meet current requirements; and (4) properties sold at 30 percent discounts were actually located in revitalization areas. The primary emphasis of our review was on U.S. Department of Housing and Urban Development's (HUD) discount sales program for nonprofit organizations and governmental agencies. However, problems noted in the approval and monitoring process related to the discount sales program are also applicable to nonprofit organizations' participation in other FHA single family programs.

The audit disclosed serious problems with HUD's discount sales program which brings into question the viability of the program.

Low and Moderate Income Homebuyers did not Benefit Significantly from the Discount Sales Program

HUD's current regulations, guidelines, and controls have allowed profit motivated entities and individuals to manipulate the program and reap the benefits of discounted sales prices under HUD's Real Estate Owned (REO) discount sales program. As a result, low and moderate income homebuyers have not benefited significantly from the approximate \$220 million in discounts given under the program during the period January 1, 1998 through April 30, 2001. During this period we identified nearly 4,000 REO discount sale properties that were subsequently resold by the original nonprofit agencies to individuals who obtained FHA insured mortgages. Analysis of information relating to these resales revealed the following:

- The average resale price of the properties by the nonprofit agencies was 30 percent higher than HUD's as-repaired value of the property. For those nonprofit organizations with 5 or more identified FHA insured resales, the average resale price ranged from 93 percent to 167 percent of HUD's REO as-repaired value of the properties.

- The average resale price by the nonprofit agencies, in relation to the subsequent FHA appraised value of the properties, was 98 percent.
- Gifts were provided by the nonprofit agencies to the mortgagors purchasing the properties from them in only 15 percent of the cases.

As shown by this analysis, the discounts provided to the nonprofit agencies were not used in any significant manner to reduce the price of properties for the benefit of low and moderate income homebuyers. In fact, rather than seeing a reduction in the resale prices (in relation to the original as-repaired values) of the properties as would be expected, there was a significant increase.

Our review suggests that a significant percentage, if not the majority, of the discount sales went to nonprofit agencies who were apparently either created by profit motivated entities and individuals, or were under the control and influence of outside parties such as realtors, investors, lenders, consultants, and rehabilitation contractors. These were the parties who primarily benefited from the program, not the low and moderate income homebuyer as the program intended. This conclusion is supported by the results of our reviews of 19 nonprofit organizations. Fifteen of these organizations had either been formed by profit motivated entities or individuals, many of whom were former investors involved in purchasing REO properties, or were legitimate nonprofit agencies who allowed other entities to use their name for a fee.

Abuses of HUD's program for discount sales to nonprofit organizations have resulted from a deficient initial screening and approval process; lack of effective on-site monitoring; inadequate reviews of annual reports; lack of controls over resale and reporting on properties sold at a 10 percent discount; and a failure to take quick and effective actions when problems are noted. Although HUD has made important changes in its approval and monitoring processes over the last year, significant problems continue to exist.

Controls over the establishment of revitalization areas did not ensure approved areas met applicable requirements and

Controls over the Establishment of Revitalization Areas were Inadequate

standards. Consequently, areas were approved as revitalization areas, which were not economically distressed and did not meet the intent of enabling legislation. This resulted in the sale of HUD properties at a 30 percent discount (deep discount) in areas not eligible for deep discount pricing. We attributed this deficiency to the Homeownership Centers' (HOCs') failure to adequately review and document revitalization areas in accordance with outstanding instructions. Additionally, the Santa Ana and Atlanta HOCs did not ensure that properties listed and sold at 30 percent discounts were actually located in revitalization areas, or had received appropriate waivers. We determined that at least 122 properties were sold at 30 percent discounts when they should have been sold at 10 percent discounts. The excessive discounts on these sales resulted in at least \$1.9 million dollars in lost sales proceeds. We attributed this deficiency to HUD and its Management and Marketing (M&M) Contractors' failure to implement adequate controls. Similar problems were noted in our recent audit of the Officer/Teacher Next Door Program issued June 29, 2001 (*Audit Report Number 2001-AT-0001*). This report recommended that HUD: 1) establish management controls to ensure all HOCs monitor properties as they are listed and as sales are closed to ensure they are within revitalization areas; 2) establish minimum standards for evaluating and documenting revitalization areas; and 3) review existing revitalization areas to ensure the boundaries are adequately defined and the areas qualify under present directives. Since HUD has already agreed to these recommendations, they will not be restated in this report. However, additional actions to ensure consistency in the determination of the single family homeownership rate are needed.

Auditee Comments

We provided the Office of Housing (FHA) a copy of our draft report on August 31, 2001 and received a written response to the draft on October 10, 2001. Additionally, the draft findings were discussed with FHA officials at a telephone exit conference on October 16, 2001. FHA officials agreed the discount sales program has had and continues to have serious problems. However, they felt the program should not be suspended until a more in-depth analysis of the program can be made. They believe significant steps have been taken during the last year to strengthen controls over the program and to identify and remove those participants who violated program

requirements. Further, they think these new controls could serve to mitigate future problems. FHA officials were cooperative and expressed a willingness to work with Office of Inspector General (OIG) in an effort to improve the nonprofit discount sales program. FHA's written response is included as Appendix A of this report and is further summarized at the end of each finding.



Recommendations

We have recommended the discount sales program be suspended until a review of the program can be made to determine whether it is viable or should be discontinued. If it is determined that the program be continued, we have recommended the approval, monitoring, recertification, and sanction process be strengthened to ensure only legitimate, independent nonprofit organizations participate in the program and benefits of the discount sales prices are passed on to low and moderate income homebuyers. Additionally, we have recommended instructions be provided to the HOCs relating to the computation of the single family homeownership rate for proposed revitalization areas and a process for periodically testing for sales outside revitalization areas be implemented.

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Abbreviations

CDBG	Community Development Block Grant
HOME	HOME Investment Partnership Program
HUD	Department of Housing and Urban Development
FHA	Federal Housing Administration/Office of Housing
HOC	Home Ownership Center
IRS	Internal Revenue Service
LURA	Land Use Restriction Addendum
M&M	Management and Marketing
OIG	Office of Inspector General
REO	Real Estate Owned
SAMS	Single Family Acquired Asset Management System
SFDW	Single Family Data Warehouse
SFIS	Single Family Insurance System
SFPD	Single Family Property Disposition

Introduction

HUD has long allowed nonprofit organizations to participate in the FHA single family insurance program as mortgagors and providers of secondary financing. Beginning in 1993, HUD expanded nonprofit organizations' role in its single family insurance program through the initiation of its discount sales program. HUD initiated the discount sales program on October 25, 1993, with the issuance of Notice H 93-82. The purposes of HUD's discount sales program were to "expand affordable housing opportunities and help revitalize neighborhoods while reducing HUD's inventory in a timely, efficient, and cost effective manner", and to "demonstrate HUD's commitment to homeownership." Under this program, nonprofit organizations and government agencies could obtain (purchase) HUD REO properties at a discount of 30 percent in revitalization areas and up to 15 percent in non-revitalization areas. It was intended these discounted sales would allow the nonprofit agencies to rehabilitate the properties if necessary, and then resell them to low and moderate-income homebuyers at reduced, affordable prices. HUD's discount sales program is primarily governed by regulations contained in 24 CFR part 291.



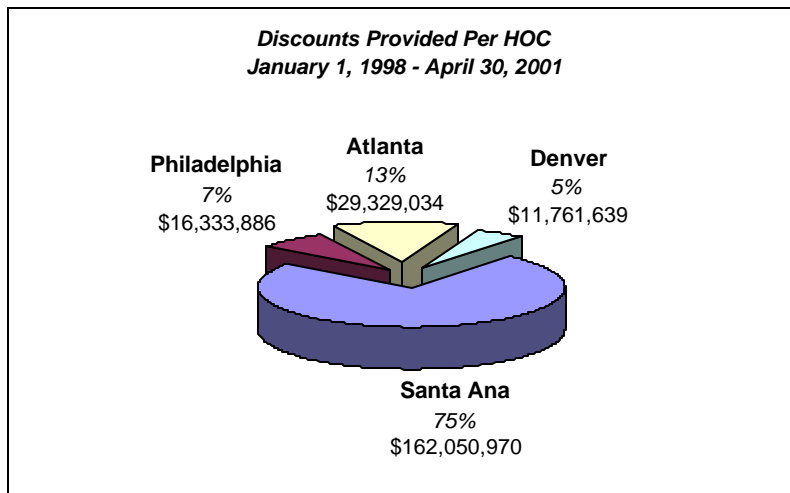
Evolution of HUD's Discount Sales Program

Since the initiation of HUD's discount sales program, HUD has issued several revisions to program requirements in various mortgagee letters and HUD notices. In mid 1994, HUD issued Notice H 94-44, which established limits on resale prices of properties purchased at a 30 percent discount, to a maximum of 110 percent of the net development cost of the property. Notice H 94-44 also established limited reporting requirements for organizations purchasing properties at a 30 percent discount. Shortly thereafter, HUD issued Notice H 94-74, which further defined the reporting requirements for organizations purchasing properties at a 30 percent discount. HUD subsequently issued Notices H 95-89, H 96-81, and H 97-62, to extend the provisions of HUD Notice 94-74. In September 1996, HUD issued Mortgagee Letter 96-52 which covered acceptable affordable housing programs and provided instructions to lenders on how to determine whether a nonprofit organization had the necessary financial capacity and management ability needed to obtain FHA-insured mortgages. HUD never implemented specific written requirements pertaining to nonprofit and government organizations' resale of properties purchased from HUD at a discount of 15 percent or less.

In March 2000, HUD issued Mortgagee Letter 00-08. This mortgagee letter consolidated, clarified and expanded requirements for nonprofit organizations' participation in HUD's FHA single family programs as mortgagors, providers of secondary financing, and participants in the discount sales program. This mortgagee letter gave the program support divisions within each Homeownership Center (HOC) responsibility for ongoing approval and monitoring of the nonprofit agencies participating or wishing to participate in the discount sales program.

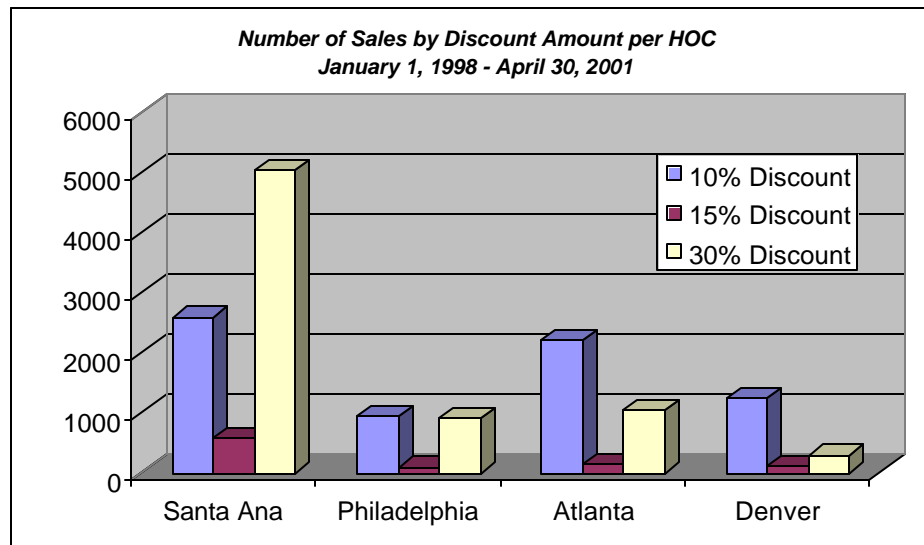
Activity Under HUD's
Discount Sales Program
During Audit Period

During our audit period, January 1, 1998 through April 30, 2001, approximately \$220 million¹ in discounts were given under HUD's discount sales program to nonprofit organizations and government agencies who purchased over 15,000 properties. As the following chart demonstrates, 75 percent of the total value of discounts went to nonprofit organizations and government agencies under the jurisdiction of the Santa Ana HOC.



The next chart shows the number of property sales to nonprofit organizations and government agencies, separated by HOC, and separated by the respective discount amounts given by HUD. In direct correlation with the above chart, the chart below shows the Santa Ana HOC had the majority (61%) of the 30 percent discount sales made during our audit period.

¹ Sales and discount amounts were obtained from HUD's SAMS system. The information, although thought to be acceptable for our purposes, was not verified for accuracy.



Dramatic Decrease in the Number of Approved Nonprofit Organizations During Audit Period

Over the last year, the number of HUD approved nonprofit organizations has been dramatically reduced from approximately 2,300 to approximately 500. Although many nonprofit organizations were removed from the program because they were inactive, numerous others were removed for violating program requirements. These violations, among other things, included excessive profits, inappropriate dealings with identity of interest contractors and lenders, shoddy rehabilitation work, and lack of administrative capacity. OIG identified many of these same violations during our audit fieldwork.

Revitalization Areas

One of the primary requirements for properties to be sold to nonprofit and government agencies at 30 percent discounts is for the properties to be located in designated revitalization areas. Notice H 93-82 first introduced revitalization areas and defined them as “an area targeted by a locality for expanding affordable housing opportunities and enhanced supportive services” and “a ZIP code where HUD owns 20 or more properties and where the average time in inventory is at least eight months.” HUD then issued Notice H 94-74 which redefined a revitalization area as “a neighborhood that has a significant concentration of vacant properties, including properties needing extensive repairs that have been in HUD’s inventory at least eight months; exhibits other characteristics of economic distress; and has been targeted by the locality for establishing affordable housing and providing adequate supportive services”. Finally, Notice H 00-16, established

new, more objective standards for evaluating and designating revitalization areas, and required one or more of the following criteria be met for the designation: (1) very low income area; (2) a high concentration of eligible assets in the area; and/or (3) low homeownership rate. Notice H 00-16 further requires HOC Directors continually monitor M&M contractor property listings to ensure revitalization area properties are properly listed and sold, and the HOCs maintain substantiating documentation to support the designation of revitalization areas.



Audit Objectives

Our primary audit objectives were to determine whether:

- HUD's existing policies, procedures and guidelines are sufficient to ensure nonprofit agencies it approves for participation in its single family insurance programs (1) are legitimate nonprofits not acting under the influence of outside parties such as realtors, consultants, investors, etc; (2) have affordable housing plans which meet HUD requirements; and (3) have sufficient previous experience to allow them to carry out their programs.
- HUD's procedures for monitoring the activities of approved nonprofit agencies are adequate to determine if the agencies are carrying out their housing activities in accordance with their housing plans in a fiscally sound manner and whether the benefits of discounts received on the purchase of HUD homes are being passed on to low and moderate income homebuyers.
- HUD has procedures in place to take quick and effective actions against those organizations identified as having abused the program, and if so, whether these actions are actually taken.
- HUD has established revitalization areas in accordance with outstanding guidelines and whether it has adequate policies in place to ensure that applicable 30 percent discount home sales to nonprofit agencies are in eligible areas.
- Financial benefits resulting from discounted prices by the nonprofits included in our review are passed on to low and moderate income homebuyers, and if not, determine who has benefited.

Scope And Methodology

To accomplish these objectives, we:

- Identified and reviewed applicable HUD policies and procedures.
- Identified, obtained, and analyzed discount sales activity information from various HUD systems: Single Family Acquired/Asset Management System (SAMS), Single Family Insurance System (SFIS), and the Single Family Data Warehouse (SFDW).
- Identified and evaluated several large volume discount purchasers' activities.
- Identified and analyzed information related to approximately 4,000 discount sales where the properties were resold to purchasers who obtained FHA insured mortgages.
- Identified and evaluated internal controls available to HUD to approve and monitor nonprofit agencies participating in its FHA single family insurance programs.
- Identified and evaluated internal controls HUD actually has in place at the four Homeownership Centers to approve and monitor nonprofit agencies participating in its FHA single family insurance programs.
- Identified and evaluated HUD's procedures over approving and monitoring nonprofit agencies.
- Identified and evaluated HUD's procedures over approving and monitoring revitalization areas.
- Interviewed appropriate officials and staff at HUD, nonprofit organizations, and related parties.
- Selected and reviewed nineteen nonprofit and/or government agencies nationwide to determine how the program is actually being implemented.

As part of these reviews, we:

- Obtained and reviewed, as appropriate, property disposition files maintained by HUD's M&M contractors, FHA insurance case binder files maintained by the HOCs, nonprofit files, lender files, and escrow company/settlement agent files
- Performed on-site visits at the nonprofit offices.
- Inspected the rehabilitated properties and interviewed the purchasers.
- Performed on-site visits, as necessary, to the applicable lender and escrow company/settlement agent responsible for the resale.
- Performed various public record searches.

Our selection of nonprofit organizations for review was not made on a statistical sampling basis. Rather, we attempted to review those nonprofits approved under Mortgagee Letter 00-08 with the greatest purchase activity in each of the HOCs, plus several smaller newly approved organizations. The 19 nonprofit organizations we reviewed represented less than one percent of the approximate 2,300 approved organizations at the beginning of the audit period and approximately four percent at the end, but accounted for 11.33 percent (1,700 of 15,000) of HUD's discount property sales and 10.25 percent (\$23 million of \$220 million) of the discounts nonprofit organizations received during the audit period.

We performed our survey and audit work at HUD Headquarters, the four Homeownership Centers, and several nonprofit and/or government agencies between April 2000 and July 2001. We conducted the audit in accordance with generally accepted governmental auditing standards.

Current Controls Over Nonprofit Organizations Do Not Ensure The Benefits Of Discount Sales Are Passed On To Low And Moderate Income Homebuyers

HUD's current regulations, guidelines, and controls have allowed profit motivated entities and individuals to manipulate the program and reap the benefits of discounted sales prices under HUD's REO discount sales program. As a result, low and moderate income homebuyers have not benefited significantly from the approximately \$220 million² in discounts given under the program during the period January 1, 1998 through April 30, 2001. During this period, we identified nearly 4,000 REO discount sale properties that were subsequently resold by the original nonprofit agencies to individuals who obtained FHA insured mortgages³. Analysis of information relating to these resales revealed the following:

- The average resale price of the properties by the nonprofit agencies was 30 percent higher than HUD's as-repaired value of the property. For those nonprofit organizations with 5 or more identified FHA insured resales, the average resale price ranged from 93 percent to 167 percent of HUD's REO as repaired value of the properties.
- The average resale price by the nonprofit agencies, in relation to the subsequent FHA appraised value of the properties, was 98 percent.
- Gifts were provided by the nonprofit agencies to the mortgagors purchasing the properties from them in only 15 percent of the cases.

As shown by this analysis, the discounts provided to the nonprofit agencies were not used in any significant manner to reduce the price of properties for the benefit of low and moderate income homebuyers. In fact, rather than seeing a reduction in the resale prices (in relation to the original as-repaired values) of the properties as would be expected, there was a significant increase.

² Sales and discount amounts were obtained from HUD's SAMS system and the information, although thought to be acceptable for our purposes, was not verified for accuracy. REO discount sales for the period totaled over 15,000 properties.

³ Identification of these resales was made by matching sales per SAMS information with information from the Single Family Data Warehouse. Matches were dependent upon property addresses, and because of the different ways addresses were put into the systems, many resales could not be identified. Accordingly, the number of REO discount sales to nonprofit organizations that were subsequently resold with FHA insured mortgages is likely much greater than the 4,000 properties we did identify.

Our review suggests that a significant percentage, if not the majority, of the discount sales went to nonprofit agencies who were apparently either created by profit motivated entities and individuals, or were under the control and influence of outside parties such as realtors, investors, lenders, consultants, and rehabilitation contractors. These were the parties who primarily benefited from the program, not the low and moderate income homebuyer as the program intended. This conclusion is supported by the results of our reviews of 19 nonprofit organizations. Fifteen of these organizations had either been formed by profit motivated entities or individuals, many of whom were former investors involved in purchasing REO properties; or were legitimate nonprofit agencies who allowed other entities to use their name for a fee.

Abuses of HUD’s program for discount sales to nonprofit organizations have resulted from a deficient initial screening and approval process; lack of effective on-site monitoring; inadequate reviews of annual reports; lack of controls over resale and reporting on properties sold at a 10 percent discount; and a failure to take quick and effective actions when problems are noted. Although HUD has made important changes in its approval and monitoring processes over the last year, significant problems continue to exist. HUD officials have recognized the continuing problems with the discount sales program and are committed to taking action to strengthen program controls.

It should be noted that although the emphasis of our audit was on those nonprofit agencies that had been approved for participation in HUD’s discount sales program, these same nonprofits, in many cases, were also approved to participate in other FHA single family areas including providing secondary financing and obtaining FHA insured mortgages with the same terms as owner occupants. Further, the internal HUD process for approval of nonprofit organizations to participate in these two areas is the same as for approval to participate in the discount sales program. Accordingly, problems noted in our review are also applicable to the approval and monitoring process in these other areas.




Governing Requirements
and Program History

HUD has long allowed nonprofit organizations to participate in the FHA single family insurance program as mortgagors. Beginning in 1993, HUD expanded nonprofit organizations’ role in its single family insurance program through the initiation of its discount sales program. Under this program, nonprofit organizations could purchase HUD REO properties at a discount, 30 percent in revitalization areas and 10 percent (15 percent if five or more properties were purchased at the same time) in non-revitalization areas (Notice H 93-82). The intent of the discounted sales program was to “expand affordable housing opportunities and help revitalize neighborhoods while reducing HUD’s inventory in a timely, efficient, and cost

effective manner” and to “demonstrate HUD’s commitment to homeownership.” It was intended that these discounted sales would allow the nonprofit agencies to rehabilitate the properties (if necessary) and then resell them to low and moderate income homebuyers at a reduced price.

In mid 1994, HUD staff raised concerns about nonprofit organizations and public (governmental) agencies reaping “windfall profits” from their resale of discounted properties purchased from HUD. As a result, HUD established limits on resale prices of properties purchased at a 30 percent discount. These new rules (Notice H 94-44) limited the resale price of a property by the nonprofit or governmental agency to a maximum of 110 percent of the net development cost of the property. Net development cost was exclusive of overhead, profit, or developer fee. In concert with this limitation, an optional land use restriction addendum was suggested which specifically limited the resale price of the properties to 110 percent of net development cost. This addendum, at the option of the local HUD office, was to be added to the sales contract in an attempt to ensure that nonprofit and public agencies were adhering to the resale price restrictions. Because of continuing concerns with resale prices of discount properties, HUD made use of an amended land use restriction addendum mandatory in 1996 for all 30 percent discount sales to nonprofit organizations and governmental agencies (Memorandum dated June 14, 1996). However, no specific written restrictions were placed on the resale of properties purchased at a discount of 15 percent or less.

Notice H 94-44 also established limited reporting requirements for organizations purchasing properties at a 30 percent discount. Essentially, they were required to report annually on their program accomplishments over the previous year and could be denied further participation in the 30 percent discount program until the report was received. The requirements of this report were further defined in Notice H 94-74. Specifically, the report was to contain the number of properties acquired from HUD at a 30 percent discount during the previous year and, for each of these properties resold in the period, a cost reporting to include: acquisition cost; rehabilitation cost; resale price; and an overview of other costs including developers fee. Additionally, the organization was to certify that the resale buyers’ incomes

were at or below 115 percent of median income for the area. HUD offices were to establish a process to ensure the reports were received and reviewed to make sure the organizations were adhering to the terms of the program. HUD did not establish efficient procedures for initial approval and ongoing monitoring of nonprofit organizations participating in the program, and to a large extent, program requirements and activity was ignored.

During early 1996, HUD noticed an expansion in the number of nonprofit organizations entering its housing programs. In order to ensure these nonprofits organizations' housing programs met HUD's requirements and they had the necessary management ability and financial capacity, HUD issued additional guidelines in September 1996. These guidelines, set out in Mortgagee Letter 96-52, covered acceptable affordable housing programs and provided instructions to lenders on how to determine whether a nonprofit organization had the necessary financial capacity and management ability needed to obtain FHA-insured mortgages.

In March of 2000, HUD attempted to address continuing concerns about the program with the issuance of Mortgagee Letter 00-08. This mortgagee letter consolidated requirements for nonprofit organizations' participation in HUD's single family programs as mortgagors, providers of secondary financing, or participants in the discount sales program. The mortgagee letter also required all nonprofit organizations to provide recertification documents to HUD within 45 days or lose their approval status. These recertification documents were to include all documents necessary for initial approval plus a detailed summary of purchase and resale of properties purchased under the 30 percent discount sales program during their previous period of approval. The Program Support Divisions of each HOC were given responsibility for reviewing these recertifications and determining whether the nonprofit organizations would continue to be approved for the various FHA programs. Additionally, the Program Support Divisions were given responsibility for ongoing approval and monitoring of the nonprofit agencies participating or wishing to participate in FHA single family programs.

In conjunction with the implementation of the requirements of Mortgagee Letter 00-08, all four HOCs have taken significant steps to strengthen controls over nonprofit approval and recertification. In fact, over the last year, the number of approved nonprofit organizations has been reduced from approximately 2,300 to approximately 500. Although many of those nonprofit organizations removed from the program were inactive, numerous others were removed based upon information identified by HUD during the recertification process. However, as discussed below, procedures for ensuring the integrity of the program are still inadequate, as a result; the program continues to be abused.

Results Of Site Reviews

During our audit we visited and reviewed the operations of 19 nonprofit organizations. All but six of these organizations had been approved (or recertified) under the provisions of Mortgagee Letter 00-08. We found none of the 19 nonprofit organizations passed on discounts resulting from the REO purchase to the homebuyers in the form of discounted sales prices, and for 15 nonprofits (these 15 nonprofit organizations purchased 1,090 properties, receiving \$15.5 million in discounts). We found the organizations' affordable housing programs were under the control of other profit motivated individuals or entities, or were formed by such individuals to take advantage of HUD's discounted sales program. Specifically:

- Two nonprofit agencies were formed by the same investors solely to participate in the discount sales program. These individuals had previously participated as investors purchasing HUD REO properties. The single office of the two nonprofit organizations was located within the office of an investment and realty firm of the involved individuals. These individuals obtained funds from the property transactions not only through the profit on the resale of the properties, but also through realty fees, exorbitant financing fees (up to 12 percent loan origination fees) and interest, and through other miscellaneous charges. As a result, there was no monetary benefit passed on to the low and moderate income homebuyers (total 115 purchases – discounts received \$3.1 million). These individuals were also involved with another nonprofit organization that

purchased 74 properties (discounts totaling \$1.7 million) during our audit period. We did not review the operations of this other nonprofit organization. However, HUD removed it from the program because of numerous problems including identity of interest relationships and excessive profits.

- An individual who had previously participated as an investor purchasing REO properties formed, or helped to form, two nonprofit organizations. We could not locate a physical office for either nonprofit organization. The nonprofit organizations took funds out of the transactions through claimed rehabilitation costs passed through identity of interest rehabilitation contractors and residual funds (profit) from the resale of the properties. The properties were resold to individuals at high end appraised values and the only benefit received by the low and moderate income purchasers was downpayment and closing cost assistance in some instances (total 98 purchases - discounts received \$2.8 million). Our inspections of properties involving these nonprofit organizations identified serious deficiencies with the quality of rehabilitation work done (or not done) on the properties. Several of the properties have major building code violations that the city is now holding the low income homebuyers responsible for correcting. As a result, not only did the ultimate purchasers (who obtained FHA insured loans) pay an excessive purchase price for the properties, the properties in many instances have serious problems, which limit their habitability. Some of the homeowners have even gone into default on their FHA-insured mortgages because they had to use their limited funds to make needed repairs on the properties they purchased.
- A profit motivated firm, which was initially established for the purpose of purchasing and rehabilitating properties (investor), converted to a nonprofit organization and was approved to participate in HUD's discount sales program. In order to induce HUD to approve its application, it provided financial statements that grossly overstated its operating income and assets. Additionally, the organization had an identity of interest

with its principal rehabilitation contractor, could not support its claimed rehabilitation costs, used high rate interim financing (16 percent interest and 5 percent origination fee), and resold the properties at prices greatly exceeding the program limit of 110 percent of net development costs (up to 137 percent of net development costs on the transactions we reviewed). This nonprofit organization should never have been approved to participate in the discount sales program and has not passed on the benefits of its discounts to low and moderate income homebuyers (total 8 purchases - discounts received \$72,000).

- An investor reactivated a nonprofit organization (inactive for at least five years) and obtained HUD approval to participate in the discount sales program. The nonprofit organization's activities were managed under an agreement with a realtor who was also the listing broker on the property resales and who also at times provided interim financing to the organization. The nonprofit sold discount properties to employees and an affiliated realtor, did not ensure that ultimate purchasers were low and moderate income, and resold 30 percent discount properties to the ultimate purchasers for more than 110 percent of claimed net development costs. Additionally, the nonprofit organization submitted inaccurate information to HUD relating to prior experience in order to meet the experience requirements for original approval (total 150 purchases - discounts received \$2.9 million).
- A nonprofit organization was created by a realtor (President) and rehabilitation contractor (Vice-President) who were formerly involved together in the purchase and sale of HUD owned properties. After purchasing discount properties from HUD, the nonprofit organization would verbally contract out any needed rehabilitation work with one of two rehabilitation contractors, including a firm set up by the nonprofit organization's vice-president after he left the organization. In addition to his salary, the president also received realty fees on the resale of the nonprofit organization's properties. The nonprofit organization

received compensation from the transactions through miscellaneous fees on top of its claimed profit on the resale of the properties. The nonprofit agency did not ensure properties were resold to low and moderate income homebuyers and resold properties at prices greatly exceeding 110 percent of net development costs (up to 156 percent of net development cost). The homebuyers received no benefit from the program other than limited downpayment and closing cost assistance. The organization was operated for the personal gain and benefit of its organizers (total 33 purchases - discounts received \$300,000).

- A nonprofit organization used the REO discount sales program to accumulate a large real estate portfolio, which at the time of our review totaled over 400 rental properties. The organization had no program to provide home ownership opportunities to low and moderate income homebuyers. The nonprofit organization purchased properties using HUD's discount program, obtained conventional financing for the interim rehabilitation period, and then refinanced the properties using FHA insured mortgages. The nonprofit organization used an identity of interest firm to perform its rehabilitation work and could not support claimed rehabilitation costs, stating that supporting documentation had been purged from its files. During our audit period, the nonprofit organization purchased 339 REO discount properties receiving over \$3 million in discounts. In addition to failing to meet the objectives of the discount sales program, the nonprofit's use of FHA insured mortgages to finance its properties has resulted in a significant risk to the FHA insurance fund. At the time of our review, the nonprofit organization had 370 active FHA insured loans with original mortgage balances totaling over \$19 million.
- Seven of the nonprofit agencies were existing organizations with no previous housing experience which were recruited by, or solicited, other individuals who managed the program on the nonprofit organizations' behalf. These other individuals handled practically all phases of the purchase, rehabilitation, and

resale of the properties and passed on a fee to the nonprofits for each sale. Essentially, the nonprofits had almost no involvement in the programs. The individuals siphoned off the benefits of the reduced purchase prices of the properties through payments to themselves or identity of interest entities for high interest financing, unsupported rehabilitation costs, realty fees, developers fees, consultant fees, and other miscellaneous charges to the program. The low and moderate income homebuyers did not receive reduced cost housing since they purchased the properties from the nonprofit organizations at full (high-end) appraised values (total 350 purchases - discounts received \$4 million).

- The other three nonprofit agencies reviewed were either city governments or community housing development organizations, which were also participating in their city's HOME Investment Partnerships Program (HOME) and/or Community Development Block Grant (CDBG) programs. These programs also failed to provide low and moderate income homebuyers reduced price housing since the properties involving these entities were resold to low and moderate income homebuyers at full appraised value (high end appraised values). This primarily resulted from the extensive, and sometimes unnecessary, amount of rehabilitation work done to the properties, but also involved other factors.

In one instance, a city essentially acted as a straw buyer for profit motivated entities. The city would purchase the properties and immediately sell them to other entities, which would rehabilitate and sell the properties at high end appraised values. These entities were allowed to make a profit equal to 15 percent of their claimed total acquisition, rehabilitation, and resale costs. As a result of this arrangement, there was no incentive to limit costs, other than the limitations resulting from the high end appraised values of the properties obtained at their resale. Such an arrangement also resulted in extra closing costs because of the interim sale to the profit motivated entities. Further, the city did not verify the profit motivated entities' claimed costs.

During our review, we performed a limited analysis of costs claimed by profit motivated firms participating in the city's program. Based upon information reviewed, it was apparent that at least one of the entities was charging ineligible development costs such as bonuses to employees, referral fees, and other miscellaneous costs which were either not related to the properties or which should have been included as part of the 10 percent allowance for profit and overhead. Additionally, because of the limited nature of our review and the entity's dealings with identity of interest contractors, we were unable to determine the validity of claimed rehabilitation costs.

Problems affecting nonprofit organizations' operations are not isolated to those included in our sample review. Over the last several years, there have been numerous other instances in New York, Chicago, San Francisco, Washington D.C., and other cities where nonprofit organizations were involved in fraudulent transactions involving HUD's discount sales programs or the FHA single family insurance program. Additionally, HUD's reviews have identified other serious problems affecting the program. For example, during the period April 1, 2000 to April 30, 2001, nonprofit agencies that purchased 68 percent of HUD's discount properties (excluding sales to governmental agencies) were subsequently removed from the program for violating program requirements. These violations, among other things, included excessive profits, inappropriate dealings with identity of interest contractors and lenders, shoddy rehabilitation work, and lack of administrative capacity.



Initial Approval

Current procedures and controls are inadequate to ensure nonprofit organizations are legitimate organizations who are not operating under the control of other parties, have the administrative capacity to carry out a rehabilitation and sales program, and will pass on the benefits of the discount sales programs to the low and moderate income homebuyers as intended. Specifically, insufficient information is obtained during the approval process for HUD to make an informed decision regarding the independence and capability of the nonprofit organization:

- Copies of the nonprofit organizations' 501 (c)(3) applications to the Internal Revenue Service (IRS) requesting tax exempt status under 501(a) of the Internal Revenue Code are not obtained and reviewed during the approval process. This information should be obtained and reviewed to determine the original purpose of the nonprofit organization and whether this is compatible with the management of a housing purchase and sales program.
- Face-to-face interviews were not held with the principals of the nonprofit organizations to obtain a clear understanding of how they would carry out their affordable housing program. Such interviews would be invaluable in determining whether the nonprofit organizations would be running their own programs or essentially acting as fronts for other parties. Additionally, face-to-face interviews would assist in making a determination as to whether the nonprofit agencies have the knowledge and administrative capability to carry out their housing programs.
- Physical inspections were not made of the nonprofit organizations' facilities to determine whether they had appropriate office space to carry out the program or even whether the claimed offices existed and were not just mailbox addresses.
- Appropriate public records checks were not done to determine involved parties' relationships with other profit-motivated entities, which could indicate that the nonprofits were just fronts. Such checks would have identified many nonprofit agencies which were formed by investors, realtors, and others to take advantage of the discount sales program and other benefits provided to HUD approved nonprofit agencies. However, at our urging, the HOCs, especially the Santa Ana HOC, have begun to use public record sources in some instances to identify related parties.
- HUD allowed non-housing experience, i.e. other social service program experience, to be considered when determining whether nonprofit agencies had sufficient

experience to manage their proposed affordable housing programs. Experience with non-housing related social programs does not provide a nonprofit organization with the background to run a housing rehabilitation program. Allowing such experience has significantly contributed to the problems affecting the REO discount sales program. During our review, we noted numerous instances where nonprofit organizations were recruited by realtors, investors, rehabilitation contractors and other profit motivated entities to act as a front for their activities. Essentially, the profit-motivated entities helped the nonprofit organizations to obtain participation approval from HUD and then ran all aspects of the nonprofits' so-called affordable housing programs. The nonprofits had almost no role in the program and simply received a fee for allowing the profit-motivated entities to use their name.

- Staff were not always adequately trained in reviewing and approving nonprofit applications; as a result, approved organizations that, based upon information in the file, were clearly under the influence of outside parties or who did not have the capability to carry out an affordable housing program.
- Government agencies were not required to submit the same approval information as other nonprofit organizations and were approved solely based on their government status without review of their proposed programs.

As a result of the deficiencies in the approval process, nonprofit organizations were approved when they should have been rejected because of their lack of administrative or financial capacity, lack of experience, or inappropriate identity of interest relationship with other parties. This was clearly evident during our review. In addition to the 19 nonprofit organizations we visited (sixteen of which should never have been approved for participation in the program), we also reviewed applications of newly approved nonprofit organizations. Problems or unresolved issues were identified with eight of the 11 applications reviewed. For example:

- One nonprofit organization was approved even though it had existed for less than two years, it had no financial resources, its founders and executives were realtors and lenders, and it had no previous experience in housing (or anything else). Obviously, this nonprofit organization did not meet the requirements for approval.
- A nonprofit organization was approved even though its application stated that a construction contractor would manage its affordable housing program. The construction contractor was to be responsible for all phases of the program including identification of properties, purchase and rehabilitation of the properties, and ultimate resale of the properties. This was not surprising since the nonprofit organization had no previous housing experience and its principle activity was to assist college bound students in obtaining financial aid.

On-Going Monitoring And Review Of Submitted Reports And Recertifications

HUD's on-going monitoring of nonprofit organizations' operations, including reviews of annual reports and bi-annual certifications and on-site reviews of operations, does not provide sufficient oversight to ensure those participating in the program are adhering to program guidelines and requirements. Consequently, nonprofit organizations which are abusing the program are not identified, or not identified on a timely basis, and so continue to participate, reaping benefits which should be going to low and moderate income homebuyers.

Onsite Monitoring of Nonprofit Organizations' Operations

HUD had not established a structured method for conducting onsite monitoring of nonprofit agencies or even identifying nonprofit agencies that should be reviewed. As a result, on-site monitoring was almost non-existent over the past few years. In fact, we could not identify any on-site reviews performed by the Santa Ana HOC even though discounts provided through this HOC amounted to approximately 75 percent of the nationwide total during our audit period. Site visits by the other HOCs have only been made recently and were very limited.

In an attempt to address the lack of on-site monitoring, HUD, in September 2000, entered into two pilot contracts with private firms to conduct on-site evaluations of nonprofit organizations' operations. As of May 30, 2001, the two contractors had

completed 15 reviews. However, HUD had no specific procedures in place to identify potential problem nonprofit organizations and direct their limited review resources to these organizations. For example, there were no specific criteria used to select the nonprofit organizations which HUD's two contractors reviewed. Without clear procedures for identifying potential problem organizations, HUD's limited resources will not be directed to those organizations which represent the greatest risk to the nonprofit REO discount sales and related programs.

Additionally, based upon our evaluation of the contractor reviews, it was apparent the scope of the reviews in many instances was too limited to provide a meaningful evaluation of the nonprofit organizations' operations. Specifically, there was insufficient analysis of potential conflict of interest relationships between the nonprofit agencies, realtors, lenders, investors, and rehabilitation contractors; claimed rehabilitation work was not adequately verified; and financing arrangements were not reviewed for reasonableness. As a result, HUD did not always receive enough information from the contractors to facilitate a truly informed decision as to the legitimacy and capability of the nonprofit organizations reviewed. For example, our review of a contractor's report and examination of other available information raised concerns about the nonprofit organization's operations including: exclusive relationships with realtors, lenders, and contractors involved in the program; reasonableness of costs; and excessive profits on the resale of properties. However, the contractor concluded that the operations of a nonprofit were acceptable and in conformance with HUD requirements.

Review of Annual Reports
And Bi-annual
Recertifications

HUD's reviews of the nonprofit organizations' annual reports and bi-annual recertifications are not adequate to identify existing problems with nonprofit organizations and their operations. For example, all but six of the 19 nonprofit organizations we selected for review had been recertified or approved under the provisions of Mortgagee Letter 00-08. These reviews failed to identify the serious problems we found with 10 of the nonprofit organizations. The causes for these deficient recertification reviews are similar to those for the deficient initial approval process, including failure to review for identity of interest relationships, inadequate staff training, and a

lack of sufficient information on which to analyze the nonprofits' performance. In order to improve the recertification review process, HUD needs to:

- Require the nonprofit organizations to provide identifying information on rehabilitation contractors used, realtors involved, and lenders providing interim construction financing (including origination fees and interest rate charges).
- Compare cost of rehabilitation claimed to that identified by HUD's M&M contractors, and follow-up on significant cost differences.
- Compare the resale price of properties to HUD's established as repaired property values and follow-up when it is determined that a nonprofit organization consistently resells properties it purchases at a discount for significantly more than HUD's established property values⁴.
- Conduct public record checks on nonprofit organizations' principals and involved rehabilitation contractors, realtors and lenders in order to identify potential identity of interest relationships.
- Perform on-site visits to the nonprofit organizations when warranted.
- Provide detailed training to staff (involved in reviewing reports and recertifications) on identifying unusual and unreasonable costs, use of public records to identify potential identity of interest relationships, typical loans transactions, etc.
- Adopt methods to provide consistency between the HOCs in the determination of net development costs and corresponding profits on nonprofits' property resales. During our review, each of the four HOCs had different procedures for reviewing annual reports and determining

⁴ HUD ceased collecting information on as repaired property values in approximately August 2000. However, in our opinion, these values could be obtained in the future without much additional effort.

whether the nonprofit organizations were adhering to the limitations on maximum sales prices of the discount properties the nonprofit organizations had purchased and resold. We did note that the Santa Ana HOC had developed and was utilizing what they called an Excess Profit Calculator when determining net development cost. In our opinion, this or a similar type tool should be adopted by each HOC and applicable staff trained in its use.

Controls Over Properties Sold At a 10 Percent Discount

Currently, HUD has no effective requirements or controls regulating nonprofit organizations' resale of properties sold to them at a 15 percent or less discount. There are no specific requirements set out in the governing mortgagee letters and housing notices which discuss resale values of the properties, limitations on who the properties can be sold to, or annual reporting requirements. Essentially, nonprofit organizations' purchasing properties from HUD at a discount of 15 percent or less felt they could do what they wished with the properties they purchased as long as the general goals of their affordable housing plan were superficially met. Additionally, we question whether the discount sale to nonprofit organizations of properties that require little or no repairs is a cost effective means to provide homeownership opportunities to low and moderate income homebuyers.

Controls Over Resales

During our review, we noted numerous instances where nonprofit organizations purchased REO properties at a 10 percent (or 15 percent) discount and immediately (often on the same day) resold them to others at significantly higher prices. Additionally, the nonprofit organizations did not ensure the properties were sold to low and moderate income homebuyers. When questioned about these practices, the nonprofit organizations claimed there were no requirements limiting the resale price or purchasers' income on such resales.

For example, one nonprofit organization purchased only properties listed at 10 percent discounts and then immediately (often on the same day) resold them to purchasers who usually paid full appraised value for the properties. The nonprofit agency did not attempt to limit its resale price of the properties to 110 percent of net development cost. In fact, even though the nonprofit agency only held its properties an average of 20

days, its average resale price was 25 percent higher than its purchase price and 119 percent of net development cost. The nonprofit organization claimed there was no requirement limiting its development fee to 10 percent of net development costs.

We see no reason for the significant accountability difference between 30 percent or 10 percent discount sales to nonprofits. The intent of the program in each instance is the same and accordingly, requirements for the two should be equally explicit. In our opinion, HUD should revise its requirements to clearly limit the allowable resale prices and allowable purchasers of 10 percent discount properties to be the same as those required for 30 percent discount sales.

Priority to Nonprofit
Organizations on 10 Percent
Discount Properties

Another concern noted relating to the sale of 10 percent discount properties is the priority given to nonprofit organizations. If a nonprofit organization and an owner occupant homebuyer submit bids to purchase a REO property, the discount to be received by the nonprofit organization is not taken into consideration when determining the highest net bidder. Accordingly, if an owner occupant purchaser submits a bid to purchase a REO property which exceeds a nonprofit organization's bid by less than 10 percent, the nonprofit organization, not the owner occupant applicant, will be awarded the property. In our opinion, such a situation violates the intent of the discount sales program, which is to provide low cost housing opportunities to homebuyers. If an owner occupant homebuyer submits a bid which is higher than the net bid of a nonprofit organization **after** taking into consideration the nonprofit organizations' allowed discount, the owner occupant homebuyer should be awarded the property. This would meet the intent of providing low cost housing opportunities to low and moderate income homebuyers without having to go through a middleman, i.e. the nonprofit organization, which simply increases the price of the property to the ultimate homebuyer.

Cost Effectiveness of 10
Percent Discount Sales for
Properties Requiring Limited
or No Repairs

Our analysis of information relating to the subsequent resale of properties requiring little or no repairs, which were purchased by nonprofit organizations at a 15 percent or less discount, raises serious concerns about the effectiveness of this program. We identified over 900 properties that were sold to nonprofit organizations at a 10/15 percent discount and subsequently resold to homebuyers who obtained FHA insured loans. Many

of these properties were resold within two weeks (or on the same day) of the nonprofit organizations' purchase date. The resale price of these properties averaged 24 percent more (\$15,500) than HUD's as repaired value of the properties and 57 percent (\$34,800) more than the nonprofit's purchase price⁵. The purchasers (for those we were able to identify) received an average gift of approximately \$6,100 to apply towards downpayment and closing costs. Essentially, they paid \$15,500 to receive \$6,100 in assistance. Obviously this is not a very cost effective method of providing downpayment assistance. Not only does the ultimate purchaser pay more for the property, HUD also receives less on its sale because of the discount. The sale to the nonprofit organization simply inserts an unnecessary middleman into the sales process which increases the costs to the low and moderate income homebuyer HUD is trying to assist. There are existing programs such as HOME, CDBG and other public and private sources that provide downpayment assistance without introducing a middleman into the sales process. In our opinion, HUD should coordinate its sales efforts with local agencies which provide downpayment assistance and eliminate the 10 percent discount sales program for properties that require limited or no repairs.

Taking Action When
Problems Are Identified

When problems are noted with a nonprofit organization's operations, HUD has not always acted in an expedient manner to remove the organization's approval to participate in the discount sales program or to take action against those who abused the program. For example, we noted HUD staff had recommended that a nonprofit's approval be removed in September 2000, yet approval was not rescinded until February 2001. During this period, the nonprofit was allowed to purchase an additional 128 discount properties with discounts totaling over \$3.5 million. This nonprofit agency was ultimately removed for taking out excessive profits on the resales of the properties; using identity of interest companies to carry out the program; sales to individuals who were not low and moderate income; and not correcting building code violations. Although the purported nonprofit agency clearly

⁵ These identified sales were properties where the difference between their as repaired and as is values was less than \$5,000, i.e. properties which in their current condition met FHA requirements or would be eligible for the escrow repair program.

violated program requirements, immediate action to revoke its approval was not taken.

There were other similar instances where the removal process was significantly delayed and the nonprofit organizations were allowed to continue to purchase properties during the delay. In our opinion, if serious concerns are raised regarding a nonprofit organization's operations, their approval should be suspended until a final determination can be made. The Santa Ana HOC did recently begin using this option when significant concerns were raised about nonprofit organizations' operations.

We also found instances where egregious problems identified by HUD only resulted in a one year removal of the organization's approval to participate in FHA single family programs, including the discount sales program. No administrative actions were initiated against the individuals who took advantage of the program (including investors who were running many nonprofit organizations' operations) nor were the nonprofit organizations required to refund excess profits to HUD or to buy down the mortgages of those low and moderate income individuals who were the ultimate purchasers of the properties.

As part of the application and approval process, nonprofit organizations agreed to abide by program requirements, therefore, if they have intentionally violated the requirements, administrative sanctions should be taken to preclude their further involvement in this and other HUD programs. Further, at the time they purchased 30 percent discount properties, a land use restriction addendum was executed, wherein the nonprofit organizations agreed to limit the resale price of the properties to not more than 110 percent of net development costs. Accordingly, as set out in Mortgagee Letter 97-5, if nonprofit organizations sold properties for more than this amount in violation of the addendum, they should be required to refund these excess profits, preferably to the low and moderate income homebuyer, through a buydown of the mortgage. If this is not possible, then the excess profits should be refunded to HUD.

Taking administrative sanctions and requiring refund of excess profits is becoming even more important as the one year exclusion period for many of the removed nonprofit

organizations is expiring and they are again applying for approval to participate in the program. These organizations should not be allowed back into the program until HUD is assured that program deficiencies have been corrected and excess profits returned. Where egregious violations occurred, the offending individual parties should be sanctioned and their organizations not allowed back into the programs.

Summary

It is apparent that there are very serious problems with HUD's discount sales program and the nonprofit approval process as a whole. As previously noted, as of May 31, 2001, nonprofit organizations who had purchased 68 percent of the discount sales during the period April 1, 2000 through April 30, 2001, had already been removed from the program by HUD. One would assume that by removing these nonprofit organizations from the program, the integrity of the program would significantly improve. However, this does not appear to be the case. Newly approved nonprofit organizations are also taking advantage of the program. For example, as of July 31, 2001, nonprofit organizations (approved under Mortgagee Letter 00-08) that purchased 81 percent of the nonprofit discount property sales at the Santa Ana HOC during the period January 1, 2001 through July 31, 2001, had already been removed for program violations. The extent of this noncompliance raises questions about the viability of this program. If HUD wishes to continue the program, significant changes must be made in its approval and monitoring process to preclude further abuse. Additionally, the need for discounted sales of properties not requiring repairs should be re-examined. Finally, procedures should be implemented to sanction individuals and organizations who abuse the program and require the refund of excess profits resulting from their purchase and resale transactions.



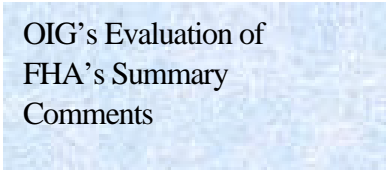
Auditee Comments and OIG
Evaluation of Auditee
Comments

On October 10, 2001, the FHA provided written comments to our draft report. FHA's complete response is included in Appendix A of this report is summarized below.

FHA's Summary Comments

In its response, FHA agreed that a study of the nonprofit discount sales program was warranted and that it would procure the services of a contractor to evaluate the program

during this fiscal year. At the completion of this review, a determination as to whether the program should be suspended would be made. FHA stated that the review is necessary to take into account the recent recertification of all nonprofit organizations. FHA went on to state that this recertification effort, in relation to the 19 agencies included in our report, resulted in six of the nonprofit agencies not being recertified; the removal of six agencies subsequent to recertification; and the pending removal of four others. FHA believed an analysis of the performance of the remaining 575 approved nonprofit agencies was desirable before reaching a determination on the continuation of nonprofit participation. FHA did express a willingness to take whatever action is necessary to ensure the discount sales program is carried out in accordance with program requirements and is in the process of issuing additional guidance and requirements to strengthen its controls over the program.



OIG's Evaluation of
FHA's Summary
Comments

We continue to believe our recommendation of the program be suspended until an evaluation of the viability of the program can be made is valid. This recommendation was made based upon our in-depth evaluation on the program activities at each of the four HOCs responsible for program administration. We recognize over the last year FHA has taken significant steps to strengthen its controls over the program and to remove those nonprofit organizations violating program requirements. However, our recommendation took into consideration both the historical aspects of the program and the effects FHA's new recertification process has had on improving the integrity of the program. As discussed in the finding, historically, the program has not served in any significant manner to reduce the price of properties for the benefit of low and moderate income homebuyers.

Our analysis of the new approval and recertification processes identified significant weaknesses that leave the program vulnerable to fraud and abuse and bring into question both the independence of those nonprofits remaining in the program and the actual beneficiaries of their activities. Additionally, it should be noted that although FHA has suspended or removed 16 of the 19 nonprofit organizations we reviewed, this action, in 13 of the 16 instances, was not taken until after OIG provided information to the HOC's regarding concerns we had with the

nonprofits' activities. Further, 10 of the 16 nonprofit organizations were approved under the new recertification requirements of Mortgagee Letter 00-08. This demonstrates the approval/recertification process even under the new requirements is flawed allowing profit-motivated entities into the program to the detriment of low and moderate income homebuyers. Accordingly, we believe the program should be suspended until an in-depth analysis of the program can be made, including a determination as to its viability and a re-evaluation of the independence of those nonprofit organizations still in the program.

Comments On Individual Recommendations

FHA also provided individual responses to each of the recommendations included in our draft report. In many instances, FHA agreed with our recommendations and stated that corrective actions were in the process of being implemented or would be implemented as soon as possible. However in other instances, FHA disagreed with our recommendations or believed actions had already been taken. Specific areas of disagreement are discussed below.

Initial Approval

FHA believed it was not appropriate to challenge or question a nonprofit's expansion of its mission beyond that which was set out in its original 501(c)(3) application, these changes do occur over time, and it is the responsibility of IRS to monitor such changes. FHA further felt that requiring face-to-face interviews with nonprofit applicants would invite criticism and claims of discrimination against nonprofit organizations and it would be costly to both the nonprofit organizations and HUD. FHA also indicated that, rather than conducting a physical inspection of nonprofit organizations' facilities as recommended, it will require submission of photographs and floor plans of the facilities. With respect to public records examinations, FHA stated such reviews of nonprofit organizations and their employees, directors, and officers are currently being done. Finally, FHA stated it recognizes the importance of staff training and has conducted ongoing training of its staff over the last year and will continue to provide staff training on all aspects of program oversight.

FHA's Comments

OIG Evaluation of FHA's Comments

The purpose of requesting original 501(c)(3) applications is not to challenge a nonprofit's expansion of its mission but to assist in obtaining a clear picture of its operations. Such information

is needed in order to determine whether the nonprofit organization is capable of, and geared towards, carrying out its planned affordable housing programs. The same purpose applies to requiring face-to-face interviews with new nonprofit applicants and physical inspections of their facilities. During our reviews, we found that in many instances the nonprofits' discount sales programs were under the control of outside parties or the nonprofits had been formed by profit motivated individuals to take advantage of the discount sales program. Had the above-mentioned actions been taken prior to the nonprofits' approval, FHA could have determined that the programs would be controlled by profit motivated entities and individuals. However, we do understand that face-to-face interviews and site inspections are not necessary in all instances. Accordingly, we have changed our recommendation to require such actions be taken on a case-by-case basis.

In relation to staff use of public records during the approval and recertification process, we noted some staff in some instances makes such reviews. However, there was no consistent review of public records. Further, staff in many instances did not know how to use the available resources in an effective manner. Accordingly, guidelines and instructions need to be instituted to assist in the use of public records. Also, staff need to be provided training to assist them in the use of these sources.

Monitoring

FHA's Comments

FHA stated M&M contractors simply determine whether required property repairs are likely to be more or less than \$5,000 and do not obtain a true estimate of all needed repairs. Accordingly, it would not be appropriate to compare the M&M repair cost estimates to the cost of nonprofit claimed repairs to assess reasonableness. Additionally, FHA stated that effective August 1, 1999, it ceased obtaining "as repaired" property values and accordingly does not have the information available to compare a property's as repaired value to the nonprofit's ultimate sales price to test for reasonableness. It also stated staff spends a significant amount of time ensuring the 110 percent net development cost is adhered to. This includes obtaining and reviewing rehabilitation invoices, HUD-1 settlement statements, and other documentation to determine whether claimed development costs are eligible and legitimate. Once obtained this information is input into an automated calculator to determine the maximum resale price. FHA agreed

public records checks of nonprofits and their principles, realtors, rehabilitation contractors, and lenders should be made. However, it felt that staff are currently making these searches to ensure that no inappropriate identity of interest relationships exist amongst their principals or associated entities. FHA also stated it recently provided training to its staff on the review of annual reports and bi-annual recertifications and it will continue to provide ongoing training.

OIG's Evaluation of FHA's
Comments

We disagree with FHA's statement that M&M contractors simply determine whether repairs will or will not exceed \$5,000. Under the terms of their contracts, the M&M contractors (through the appraisal process) are required to provide a list of needed FHA Minimum Property Requirements repairs and an estimated cost or a summary listing of general categories or areas of repair along with a general cost estimate for all properties. For properties in revitalization areas with estimated repairs of \$5,000 or more, the M&M contractors are required to provide a detailed listing of required repairs along with cost estimates. Accordingly, FHA should use this information as a general guide to determine the reasonableness of nonprofits' claimed repair costs. We agree, that effective in August 2000 (not August 1999), FHA ceased obtaining as-repaired values on properties in its inventory. However, in order to provide needed management information relating to its property sales, FHA should start obtaining this information again. This could be used to monitor the reasonableness of nonprofits' resale prices of properties they purchase under the discount sales program.

In relation to FHA's statement that it obtains and reviews nonprofits' rehabilitation invoices, this is not done, nor would it be practicable. FHA's claim that staff uses an automated calculator to determine maximum resale price also is not completely accurate. We found staff at three of the HOCs were not using this calculator nor were they adequately trained in its use. The lack of training and consistency in reviews, as previously discussed in relation to the initial approval process, is also a problem affecting staff's use or failure to use available public records when reviewing annual reports.

Sanctions and Excess Profits

FHA agreed that sanctions should be taken against nonprofit organizations that abuse the program and its current practice

FHA's Comments

includes pursuing all feasible administrative actions to penalize abusive nonprofits and prohibit them from participating in the program. In relation to the return of excess profits, FHA stated it is in the process of issuing guidance to mortgagees and nonprofits on the calculation of development costs and this guidance will inform the nonprofits they will be required to return excess profits to FHA. However, it felt it has no authority to require retroactive reimbursement of excess profits. FHA stated Mortgagee Letter 97-5 cited in our report is only applicable to lenders who are responsible for the mortgage on both the purchase and resale of a discount property. During the exit conference, FHA did agree to obtain a legal opinion as to whether it has the authority to require retroactive reimbursement of excess profits.

OIG's Evaluation of FHA's Comments

We found FHA was not actively identifying and taking administrative sanctions against organizations and individuals who abused the discount sales program. Accordingly, guidelines and procedures need to be developed to ensure administrative sanctions are taken against individuals and entities when egregious program abuse is identified. We do not agree with FHA's claim it has no authority to pursue nonprofit organizations for retroactive reimbursement of excess profits. As discussed in the finding, nonprofit organizations that purchase properties at a 30 percent discount sign a Land Use Restriction Addendum (LURA) that specifically limits the maximum sales price of such properties. If this restriction were violated, it would give HUD recourse to pursue recovery of the excess profits and use them to buydown the affected low and moderate income homebuyer's mortgage. Further, we do not understand how a lender can be responsible for requiring a buydown of a mortgage when excess sales prices are identified, but FHA is not responsible when it identifies excessive profits. It should be noted the homebuyer is the one who is affected by the excessive sales prices and FHA's failure to take action to recover these funds for the homebuyer not only is an abrogation of responsibility, but also could leave FHA subject to legal action.

Re-evaluation of the Discount Sales Program

FHA's Comments

FHA believed the 10 percent sales program serves several important purposes including a commitment by nonprofit organizations to provide an affordable housing program as part of its reinvestment in the community it serves. This commitment

OIG's Evaluation of FHA's
Comments

in FHA's judgment is worth a 10 percent discount because these other factors add additional value to a HUD home sale.

For HUD properties, where limited or no repairs are required, we do not understand what additional value is added by introducing a middleman (nonprofit) into the sales process. As discussed in the finding, this process serves to unnecessarily increase the resale price of such properties to the detriment of both HUD and the homebuyer. Accordingly, without any information to support the benefits of such a policy, this policy should be terminated.

Recommendations

We recommend the discount sales program be suspended until a review of the program can be made to determine whether it is a viable program or whether it should be discontinued. If it is determined that the program should be continued, appropriate controls to guard against fraud and abuse must be implemented. These controls should, at a minimum, address:

1A. Improving the initial approval process to require:

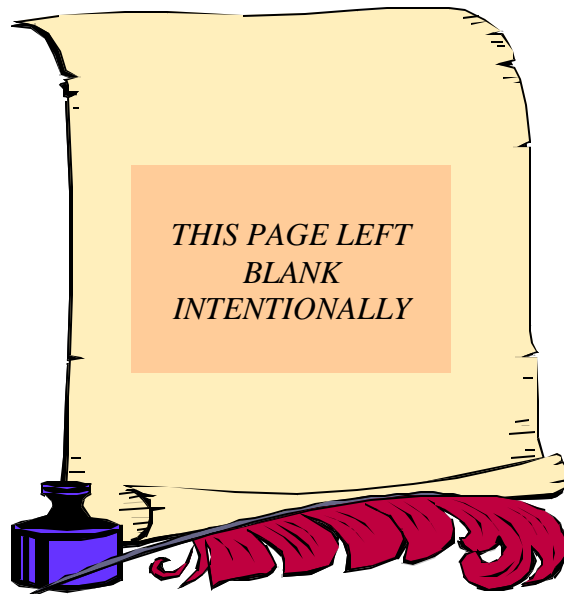
- Submission and review of nonprofit organizations' original 501(c)(3) applications to ensure their ongoing mission is compatible with the discount sales program;
- Face to face interviews, on a case by case basis, with nonprofit organization principals to obtain a clear understanding of their proposed program;
- Physical inspections of the nonprofit organizations' facilities;
- Appropriate public records checks of involved entities and individuals to identify any potential identities of interest or previous activities which could adversely affect the nonprofit organizations' programs;

- Government organizations submit the same information as other nonprofit organizations including a viable affordable housing plan; and
- Staff be provided appropriate training to assist in the review of nonprofit organization applications.

1B. Strengthen the monitoring process by:

- Developing a structured method to identify potentially problem nonprofit organizations for on-site review and specific procedures to be used when conducting on-site reviews;
- Requiring nonprofit organizations to submit, as part of their annual reports, information on realtors, lenders, and rehabilitation contractors used;
- Comparing, as part of the annual review process, cost of rehabilitation claimed to estimated repair costs identified by HUD's M & M contractors and following up on significant cost differences;
- Comparing nonprofit organizations' property resale prices to HUD's established as repaired property values and following up when the organizations consistently resell the properties for significantly higher prices;
- Conducting public records checks on nonprofit organizations' principals and involved rehabilitation contractors, realtors and lenders;
- Adopting methods to provide consistency between the HOCs in the determination of net development costs and corresponding profits on nonprofits' property resales; and
- Providing detailed training to staff on procedures to be used when performing reviews of annual reports and biannual recertifications.

- 1C. Establish specific procedures to ensure, when appropriate, individuals and organizations which abuse the program are sanctioned and excess profits are returned. Additionally, take action to seek reimbursement of excess profits from those nonprofit organizations which have previously been identified during the monitoring and recertification process and take administrative actions against those organizations and individuals who were previously identified as having violated program requirements.
- 1D. Revise requirements to specifically require properties sold to nonprofit organizations at a discount of 15 percent or less be sold to low and moderate income homebuyers at no more than 110 percent of net development cost.
- 1E. Change requirements to require that when an owner-occupant submits a bid higher than the nonprofits' net bid **after** their discount, the owner-occupant homebuyer be awarded the property.
- 1F. Re-evaluate the necessity and effectiveness of the 10 percent discount sales program for properties which require little or no repairs, and without any information to support the benefits of such a program, discontinue it.



There Were Inadequate Controls Over The Approval Of Revitalization Areas And Over The Eligibility Of Deep Discount Property Sales

Controls over the establishment of revitalization areas did not ensure approved areas met applicable requirements and standards. Consequently, areas were approved as revitalization areas, which were not economically distressed and did not meet the intent of enabling legislation. This resulted in the sale of HUD properties at a 30 percent discount (deep discount) in areas not eligible for deep discount pricing. We attributed this deficiency to the HOCs' failure to adequately review and document revitalization areas in accordance with outstanding instructions. Additionally, the Santa Ana and Atlanta HOCs⁶ did not ensure properties listed and sold at 30 percent discounts were actually located in revitalization areas, or had received appropriate waivers. We determined at least 122 properties were sold at 30 percent discounts when they should have been sold at 10 percent discounts. The excessive discounts on these sales resulted in at least \$1.9 million in lost sales proceeds. We attributed this deficiency to HUD and its M&M Contractors' failure to implement adequate controls.

Program Requirements

Notice H 94-74 Revisions to Single Family Property Disposition (SFPD) Sales Procedure, provided that HUD designate certain revitalization areas that were suitable for applying deep discount pricing (30 percent off fair market value) on HUD-owned properties offered without mortgage insurance. Under this notice, a revitalization area was defined as:

...a neighborhood that has a significant concentration of vacant properties, including properties needing extensive repairs that have been in HUD's inventory at least eight months; exhibits other characteristics of economic distress; and has been targeted by the locality for establishing affordable housing and providing adequate supportive services.

Notice H 00-16 Revitalization Area Evaluation Criteria Single Family Property Disposition (which implemented amendments

⁶ We did not review this area at the Philadelphia HOC and so we can not say whether or not this was a problem there.

to Section 204(h)(3) of the National Housing Act) established new, more objective standards for evaluating and designating revitalization areas. This notice, effective in August 2000, required one or more of the following criteria be met: 1) Very Low Income Area: The median household income for the area is less than 60 percent of the median household income for the metropolitan area or state; 2) High Concentration of Eligible Assets: A high rate of default or foreclosure for single family mortgages insured under the National Housing Act has resulted, or may result, in the area having a disproportionately high concentration of eligible assets or being detrimentally impacted by eligible assets in the area; 3) Low Homeownership Rate: The rate for homeownership of single family homes in the area is substantially below the rate for homeownership in the metropolitan area.

This notice states revitalization areas may include an entire zip code, however, areas should be more closely defined when necessary to include census tracts, census places, or even more targeted street or geographical boundaries. Notice H 00-16 further requires HOC Directors continually monitor M&M property listings to ensure revitalization area properties are properly listed and sold, and the HOCs maintain substantiating documentation to support the designation of revitalization areas.

Establishment And Review Of Revitalization Areas

We examined 21 revitalization areas established under the Santa Ana HOC's jurisdiction and five established under the Denver HOC's jurisdiction⁷. Eighteen of the Santa Ana HOC areas were established prior to, and three after, the issuance of Notice H 00-16. We found that portions or all of nine of the eighteen areas established prior to the issuance of Notice H 00-16 did not meet existing requirements. Further, documentation supporting all 18 areas' designation as revitalization areas had not been maintained by the HOC. We found the three areas established after issuance of Notice H 00-16 were eligible and their eligibility fully documented in the HOC's files. In relation to the five Denver HOC areas, we found four of the areas met current requirements. We could not determine whether the other area was established in accordance with existing

⁷ The eligibility of revitalization areas at the Philadelphia and Atlanta HOCs was not reviewed as part of this audit. However, revitalization areas at these two HOCs were addressed as part of our recent review of the Officer/Teacher Next Door Program (Audit Report Number 2001-AT-0001). Similar problems with the establishment of revitalization areas were identified in this report.

requirements because the file was missing. However, the area's designation as a revitalization area has been removed.

Due to a lack of documentation, we could not determine the basis used to initially set up the 18 previously established revitalization areas we selected at the Santa Ana HOC. However, based upon our review of information obtained from other sources, we determined 23 of 45 census tracts in nine of the 18 areas did not meet the requirements for designation as revitalization areas. In some instances, the areas did not even come close to meeting existing requirements. For example, one revitalization area in Las Vegas, consisting of six census tracts: had income averaging 101 percent of the median income for the area (ranging from 93 percent to 122 percent) versus the eligibility standard of 60 percent; and the single family homeownership rate averaged 76 percent (ranging from 67 percent to 84 percent) versus the average homeownership rate for the entire geographic area of 62 percent. Based upon our review of revitalization areas established prior to issuance of Notice H 00-16, it is apparent the Santa Ana HOC needs to re-evaluate existing revitalization areas to ensure they meet current requirements.

We also noted inconsistencies and a lack of guidance relating to the determination of the single family homeownership rate and whether the rate of the proposed revitalization area is "substantially below" the rate for the metropolitan area. Specifically, we noted the Santa Ana HOC and the Philadelphia HOC were calculating the homeownership rate incorrectly. Both HOCs computed the single family homeownership rate using the total number of owner occupied units divided by the total number of housing units, which includes both single family and multifamily units. The HOCs' inclusion of multifamily units resulted in a lower calculated homeownership rate than the correct calculation using only single family units. For example, in one instance in Las Vegas, the homeownership rate went from 22 percent to 65 percent when multifamily units were taken out of the calculation. HUD Headquarter's REO, Good Neighbor Program staff agreed that multifamily units should not be included in the calculation of a single family homeownership rate when evaluating revitalization areas as this could result in the inappropriate designation of revitalization areas that do not meet the intent of the program. Additionally, we noted there is

no guidance on what represents a single family homeownership rate which is “substantially below” the homeownership rate for the metropolitan area. In our opinion, the HOCs should be provided appropriate guidance so that they are consistent in their determinations.

HUD Deep Discount
Properties Sold Outside
Designated Revitalization
Areas

We compared lists of 30 percent discount REO sales to nonprofit organizations (for the Santa Ana HOC with closing dates between January 1998 and April 2001, and for the Atlanta HOC with closing dates between January 1997 and May 2001), to a list of revitalization area zip codes in effect at the time the sales occurred⁸. We found 54 deep discount properties that were inappropriately sold outside revitalization areas during the period at the Santa Ana HOC and 68 at the Atlanta HOC for a total of 122 inappropriate sales. Forty-one of these cases were sales directly from HUD prior to the effective date of the HOCs’ M&M contracts. The total estimated dollar amount of excess discounts for these properties was \$863,166. Eighty-one of the cases were sales by HUD’s M&M contractors. The total estimated dollar amount of excess discounts for these properties was \$1,060,883⁹. Both the Santa Ana and Atlanta HOCs have initiated actions to seek recovery of lost proceeds from the M&M contractors for these properties sold with excessive discounts.

The inappropriate deep discounts offered on sales directly from HUD, prior to the M&M contracts, were the result of errors made by HUD staff. The inappropriate sales from the Santa Ana and Atlanta HOCs’ M&M contractors were the result of the contractors’ errors, at the Atlanta HOC, and communication errors between the HOC and its M&M contractors. These errors went undetected by the HOCs and M&M contractors due to a failure to establish adequate controls to monitor these sales to ensure they occurred within appropriate areas. According to Santa Ana HOC staff, routine monitoring reviews were conducted on a sample of M&M

⁸ Some designated revitalization areas only include a portion of a zip code. Our test for sales outside revitalization areas did not differentiate between “partial” or full zip codes. Properties sold within any portion of partial zip codes were considered within the revitalization area, whether they were within the designated portion of the zip code or not. Therefore, the actual number of properties sold at a 30 percent discount outside revitalization areas was likely higher than the number found by our test.

⁹ Based on 20 percent of the Bid Amount for each property. This is equal to the difference between the 10 percent discount the property was likely eligible for and the 30 percent discount that was inappropriately given.

contractor sales, however, these reviews did not verify that 30 percent discount sales were within designated revitalization areas. HOC staff also stated they conducted some monitoring of the M&M contractors' internet property listings. However, we found this control was not effective for detecting any of the inappropriate sales. The Santa Ana HOC's M&M contractors also had some limited controls, but these were not sufficient to prevent or detect the excessive discounts. The Atlanta HOC did not start monitoring property listings, to ensure that properties listed at deep discounts were in revitalization areas, until January 2001.

Santa Ana HOC staff stated they will implement new procedures to ensure properties sold at a 30 percent discount are within designated revitalization areas such as additional verification of M&M contractor property listings and checking for inappropriate sales during the routine reviews of M&M contractor case files. Additionally, HUD Headquarters has contracted for new computer software designed to more accurately and efficiently determine if properties are within revitalization areas. The M&M contractors stated they also have implemented new controls to ensure deep discounts are only given in revitalization areas.

Corrective Actions Previously
Agreed To By HUD

A recent HUD Office of Inspector General audit report related to HUD's Officer/Teacher Next Door Program issued June 29, 2001 (*Audit Report Number 2001-AT-0001*) found similar problems with discount sales outside revitalization areas and revitalization areas that do not qualify. In response to this report, HUD agreed to take corrective actions that should resolve some of the deficiencies noted in our audit of HUD's nonprofit discount sales program. The recent HUD OIG report recommended that HUD: 1) establish management controls to ensure that all HOCs monitor properties as they are listed and as sales are closed to ensure that they are within revitalization areas; 2) establish minimum standards for evaluating and documenting revitalization areas; and 3) review existing revitalization areas to ensure the boundaries are adequately defined and the areas qualify under present directives. Since HUD has already agreed to these recommendations, they will not be restated in this report. The recommendations below are additional steps necessary to correct the deficiencies found

during our current audit of HUD's nonprofit discount sales program.

Auditee Comments

FHA agreed to provide instructions to the HOCs relating to the computation of the single family homeownership rates for proposed revitalization areas. However, FHA stated an **overall** homeownership rather than a single family homeownership rate should be used as a measure to evaluate revitalization areas. FHA felt that this calculation, which would effectively include multifamily units, would satisfy the requirements of Housing Notice H 00-16.

OIG Evaluation of Auditee Comments

In our opinion, FHA's intended method for computation of the homeownership rate for proposed revitalization areas is not consistent with Housing Notice H 00-16 and Section 602 of the HUD 1999 Appropriations Act which state the "rate for homeownership of **single family homes**" (emphasis added) should be used. Housing Notice H 00-16 indicates the overall owner occupancy rate may be considered as supplemental information, however revitalization areas should be documented based on the "**single family homeownership rate**" (emphasis added).

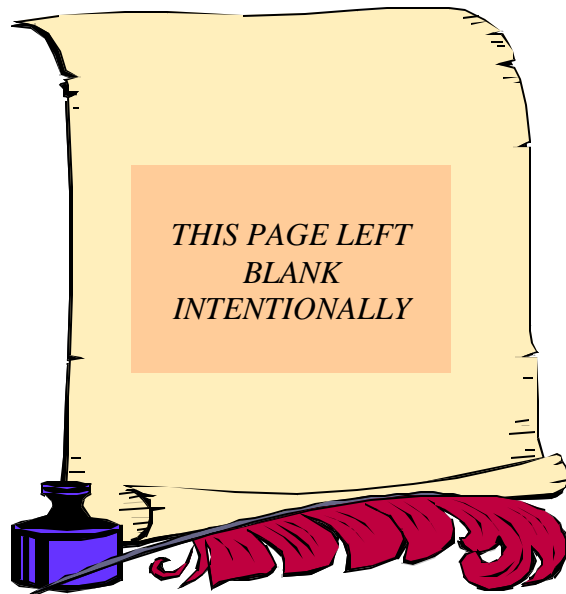
Additionally, an **overall** homeownership rate, in our opinion, is not a reliable measure as it could result in the designation of inappropriate revitalization areas. For example, a neighborhood consisting of newer homes and a luxury apartment complex could qualify as a revitalization area simply based on the proportion of apartment units to single family homes. We do not believe the intent of the enabling legislation is to designate such areas as revitalization areas.

FHA's response did not address our recommendation that guidelines be provided to the HOCs on what constitutes "substantially below" when used in analyzing single family homeownership rates. This guidance is important to ensure the HOC's are consistent in their determinations.

Recommendations

We recommend you:

- 2A. Provide instructions to the HOCs relating to the computation of the single family homeownership rate for proposed revitalization areas including the exclusion of multifamily units from the computation and guidelines on what constitutes “substantially below.”
- 2B. Implement controls to periodically test for sales outside revitalization area zip codes by matching the zip codes for all 30 percent sales during the period against the list of current revitalization area zip codes.



Management Controls

In planning and performing our audit, we obtained an understanding of the management controls applicable to nonprofit participation in single family programs relevant to our audit. Management is responsible for establishing effective management controls. Management controls, in the broadest sense, include the plan of organization, methods, and procedures adopted by management to ensure its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include systems for measuring, reporting, and monitoring program performance.

Relevant Management Controls

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

- Program Support Division initial approval process,
- Recertification process,
- Annual report review process,
- Revitalization area approval process,
- Ongoing monitoring processes, and
- Enforcement action processes.

We evaluated each management control listed above through the following audit procedures:

- Interviews with single family staff and HUD contractors;
- Reviews of single family files and other records maintained by HUD staff and/or HUD contractors;
- Evaluations of HUD established policies and procedures for approving, monitoring and enforcing nonprofit participation in single family programs, as compared with actual policies and procedures followed.

Significant Weaknesses

A significant weakness exists if management controls do not give reasonable assurance that resource use is consistent with laws, regulations, and policies; resources are safeguarded

against waste, loss, and misuse; and reliable data is obtained and maintained, and fairly disclosed in reports. Based on our audit, we identified the following significant weaknesses:

- Current controls over nonprofit organizations do not ensure the benefits of discount sales are passed on to low and moderate income homebuyers (Finding 1).
- Current controls do not ensure nonprofit organizations are legitimate and not operating under the control of other parties (Finding 1).
- Current controls do not ensure nonprofit organizations have the administrative capacity to carry out a rehabilitation and sales program (Finding 1).
- Current controls do not ensure nonprofit organizations participating in the program are adhering to program guidelines and requirements (Finding 1).
- Current controls are not adequate to ensure 30% discount sales are within designated revitalization areas (Finding 2).
- Current controls are not adequate to ensure revitalization areas meet program guidelines and requirements (Finding 2).
- Current controls are not adequate to ensure appropriate administrative sanctions are taken against nonprofit organizations that abuse the program (Finding 1).

Follow Up On Prior Audits

This was the initial audit of nonprofit participation in HUD single family programs, specifically focused on HUD's discount sales program. However, past audit reports issued by the Office of Inspector General, related to other HUD single family housing programs, have addressed similar issues detailed in this report.

HUD's Section 203(k)
Rehabilitation Mortgage
Insurance Program (97-AT-
121-0001)

On February 6, 1997, we issued an audit of HUD's Section 203(k) Rehabilitation Mortgage Insurance Program as it pertained to investor and nonprofit borrowers (97-AT-121-0001). The report concluded that 203(k) loans made to nonprofit borrowers constituted an unreasonable risk. The report identified indications of program abuse such as:

1. Land sale schemes intended to turn quick profits between identity-of-interest parties.
2. Refinance schemes intended to provide quick profits.
3. Rehabilitation work not completed or improperly performed.
4. Properties overvalued.
5. Profits to nonprofit organizations.
6. Rehabilitation loans made on properties that needed only minor maintenance.
7. Ineligible and unsupported fees.

Our current audit found similar indications of program abuse by nonprofit organizations participating in HUD's discount sales program.

We made several recommendations in the February 6, 1997 audit report, including recommendations for the Office of Housing to establish a timetable to monitor the effectiveness of the new procedures for HUD approval of nonprofit borrowers, for lender review of the nonprofit borrowers' financial capacity,

and for a decision by HUD whether to allow nonprofits to continue to participate in the program.

To date, HUD has not adequately addressed the recommendations stated above. Therefore, we are readdressing the recommendations as they pertain to nonprofit participation in all single family programs, with emphasis on HUD's discount sales program. The Department needs to take appropriate corrective actions detailed in this report to effectively address on-going problems pertaining to nonprofit participation in single family programs.

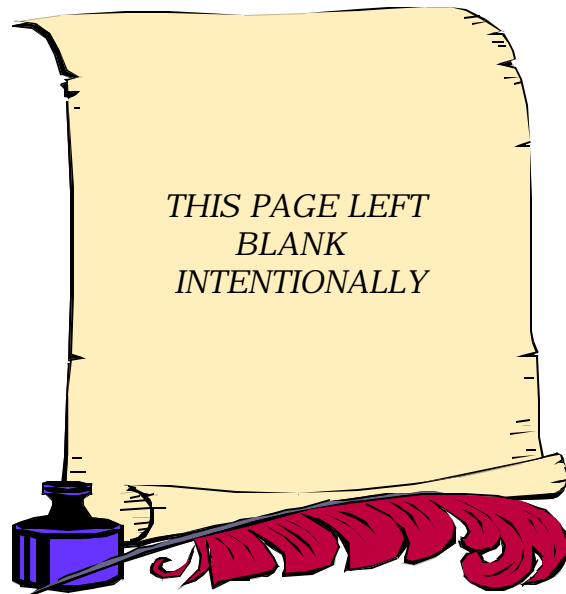
Nationwide Audit Results
on the Office/Teacher Next
Door Program (2001-AT-
0001)

On June 29, 2001, we issued an audit report on HUD's Officer/Teacher Next Door Program (2001-AT-0001). Within one of five audit report findings, we reported homes were sold outside of designated revitalization areas and attributed the causes to (1) HUD not effectively monitoring its M&M contractors, and (2) HUD not effectively communicating the revitalization areas to its M&M contractors. The finding further reported revitalization area boundaries were not adequately documented, HOCs used significantly different data sources to approve revitalization area requests, and certain homes did not appear to be in distressed communities.

Our current audit found similar problems with HUD's procedures over the designation and continual monitoring of revitalization areas as they relate to HUD's discount sales program.

We made three recommendations in the June 29, 2001 audit report relating to establishment of revitalization areas and the sale of deep discount properties. The three recommendations were addressed to the Deputy Assistant Secretary of Single Family Housing, and were as follows: (1) establish management controls to ensure all HOCs monitor properties as they are listed and as sales are closed to ensure they are within revitalization areas; (2) establish minimum standards for evaluating and documenting designated revitalization areas to ensure consistency among the HOCs; and (3) review existing revitalization areas to ensure the boundaries are adequately defined and the areas qualify under present directives.

Single Family Housing subsequently agreed to all three recommendations, so we did not restate the same recommendations in this report. However, we did add two additional recommendations in this report necessary to correct the deficiencies found during our audit of HUD's nonprofit discount sales program. HUD needs to take the appropriate corrective actions detailed in this report to effectively address on-going problems pertaining to the designation and continual monitoring of revitalization areas.



Auditee Comments



U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

OCT 10 2001

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MEMORANDUM FOR: Mimi Y. Lee, District Inspector General for Audit, 9AGA

J.C. Weicher
FROM: John C. Weicher, Assistant Secretary for Housing-
Federal Housing Commissioner, H

SUBJECT: FHA Response to Office of Inspector General (OIG) Internal Audit of
Nonprofit Organizations' Participation in HUD's Single Family Programs

Thank you for the opportunity to review and comment on your draft audit report on Nonprofit Organizations' Participation in FHA Single Family Programs. The report recommends that the nonprofit discount sales program be suspended until a review can be made to determine the program's viability.

We agree that a review of the program is warranted, and we will procure the services of a contractor to evaluate the program. This evaluation will help us determine whether a suspension of the program is appropriate. Until we have made that determination, we will continue our efforts to improve the program. As part of those improvements, we will incorporate some of the recommendations outlined in your report. Please see Attachment A for FHA's response to each of your recommendations.

We feel this review is necessary in order to take account of HUD's recent recertification of all nonprofits doing business with FHA's Office of Single Family Housing. In the course of this recertification, six of the nineteen nonprofits included in OIG's analysis were not recertified. Moreover, another six were removed from the program subsequent to their recertification, and four are pending removal. We believe an analysis of the performance of the remaining 575 nonprofits (total as of 09/01/01) is desirable before reaching a decision on the continuation of nonprofit participation. Please see Attachment B for a status report on the nineteen nonprofits reviewed in your report.

If you have any questions regarding this response, please contact Vance T. Morris, Director, Office of Single Family Program Development, at (202) 708-2121.

Attachment

Attachment A

FHA's Response to Recommendations

Summary Recommendation by the OIG:

FHA should suspend the discount sales program until a review of the program can be made to determine whether it is a viable program or whether it should be discontinued. If it is determined that the program should be continued, appropriate controls to guard against fraud and abuse must be implemented.

FHA has not determined whether suspension of the discount sales program is appropriate as this time. During FY 2002, FHA will procure the services of a contractor to engage in a more systematic and comprehensive evaluation of the Direct Sales program. FHA has responded to the OIG's other specific recommendations below.

1A: Improve Initial Approval Process

This recommendation has six subparts. FHA will respond in order of the subparts.

Subpart 1: FHA should improve the initial approval process to require: submission and review of nonprofit organizations' original 501(c)(3) applications to ensure that their ongoing mission is compatible with the discount sales program.

FHA is not in a position to challenge a nonprofit's expansion of its mission beyond that articulated in its original 501(c)(3) application. Nonprofits do change their functions over time and FHA has no authority to question such action, since FHA does not provide the original tax-exempt status, nor prohibit any modifications to the mission. The IRS has jurisdiction over this type of activity. Nonprofits must notify the IRS if there are substantial and material changes in the nonprofit's character, purposes, or methods of operation [IRS Reg. 1.501 (a)-1(a)(2), 601.201(n)(3)(ii)]. In a new mortgagee letter that will be published in the first quarter of FY2002, FHA will require that nonprofits certify their compliance with the IRS regulations.

Subpart 2: FHA should improve the initial approval process to require: face-to-face interviews with nonprofit organization principals to obtain a clear understanding of their proposed program

FHA does not conduct face-to-face interviews with applicants in any Single Family program and believes that imposing such a requirement would invite criticism that FHA was discriminating against nonprofits. It would also place a high financial burden on both the Department and the participating entity. FHA now requires

nonprofits to submit a number of documents to explain their affordable housing plan, demonstrate administrative and financial capacity, and prove that no conflicts of interest exist.

Subpart 3: FHA should improve the initial approval process to require: physical inspections of the nonprofit organizations' facilities.

FHA will change the nonprofit approval process to make it similar to the process for approving lenders to do business with FHA. We will require that photographs and floor plans of the agency's facility be submitted with the application. The floor plans must show that the nonprofit has enough space for its employees and for maintaining files in accordance with our record-keeping requirements. In addition, we will clearly state that the nonprofit must have a business mailing address and not a post office box.

Subpart 4: FHA should improve the initial approval process to require: appropriate public records checks of involved entities and individuals to identify any potential identities of interest or previous activities that could adversely affect the nonprofit organizations' programs.

FHA believes that current practices are consistent with this recommendation. FHA staff use several data sources to research the relationships between members of the nonprofit and personnel from for-profit entities. In particular, reviewers look for connections between the nonprofit and for-profit businesses that employ or are owned by key staff, directors, or officers of the nonprofits. Also, staff researches professional relationships via various automated technologies such as ChoicePoint, States' web sites for license information, County recorder web sites, and the Guidestar website, which contains information on nonprofit organizations' operations and finances. In addition, staff have compiled a database that lists the names of individuals and entities working with FHA-approved nonprofits. FHA staff will access this database to research potential conflicts of interest between for-profit groups and nonprofits.

Subpart 5: FHA should improve the initial approval process to require: government organizations to submit the same information as other nonprofit organizations including a viable affordable housing plan.

FHA believes that the nonprofit approval process is not appropriate for governmental entities, because a number of the records and documents FHA requires from nonprofits are simply not available for municipalities. However, FHA is in the process of establishing an approval process suitable for government entities. This process will be different from the nonprofit process, but will have a similar intent – to evaluate the capacity of the governmental entity to carry out its affordable housing plan. The process will be completed during FY 2002.

Subpart 6: FHA should improve the initial approval process to require: staff to be provided with appropriate training to assist in the review of nonprofit organization applications.

FHA agrees that training staff is critical to the success of the program. FHA has conducted ongoing nonprofit oversight and monitoring training for staff since the nonprofit recertification effort began in March 2000. Training included weekly conference calls, one-on-one training by program managers and interactive satellite (PicTel) training. Most recently, in August 2001, FHA staff from headquarters and all four Homeownership Centers (HOCs) participated in a comprehensive training held in Washington, DC. The training covered the application process, the annual report review process, assessing financial and administrative capacity, determining low-income status and calculating net development costs, conducting desk reviews, and on-site monitoring procedures. OIG Senior Auditor, Clyde Granderson spoke at the training, and discussed with Program Support staff tools that can be used to aid in identifying and prohibiting nonprofits that have conflicts of interest from participating in FHA programs. Mr. Granderson provided staff with website information and techniques they can utilize to better identify potential problems. FHA intends to continue training staff on all aspects of program oversight.

1B. Strengthen Monitoring Process

This recommendation has seven subparts. FHA will respond in order of the subparts.

Subpart 1: FHA should strengthen the monitoring process by: developing a structured method to identify potentially problem nonprofit organizations for on-site review and specific procedures to be used when conducting on-site reviews.

FHA is in the process of securing a business support contract to assist FHA in implementing this recommendation. FHA expects to implement this recommendation during FY 2002.

Subpart 2: FHA should strengthen the monitoring process by: requiring nonprofit organizations to submit, as part of their annual reports, information on realtors, lenders, and rehabilitation contractors used.

FHA will update its annual report instructions for nonprofits, requiring the submission of information on the realtors, lenders, and rehabilitation contractors used. Staff will conduct background and public records checks on all of these business partners. This change will be implemented during FY 2002.

Subpart 3: FHA should strengthen the monitoring process by: comparing, as part of the annual review process, cost of rehabilitation claimed to estimated

repair costs identified by HUD's M & M contractors and following up on significant differences.

The rehabilitation costs identified by the M&M contractors are not appropriate for this purpose. The contractors simply determine whether the repairs are likely to be over or under \$5,000 so that the property is properly listed as eligible for normal FHA-insured financing (generally 203(b)) or only eligible with a 203(k). Since the M&M does not get a true "as repaired" estimate, it would not be appropriate for FHA to compare the M&M figure to the eventual repair costs to assess the reasonableness of the rehabilitation costs.

Subpart 4: FHA should strengthen the monitoring process by comparing nonprofit organizations' property resale prices to HUD's established as repaired property values and following up when the organizations consistently resell the properties for significantly higher prices.

FHA no longer captures an "as repaired" property value. Mortgagee Letter 99-18, issued on June 28, 1999, announced the new Appraisal Handbook, 4150.2, Valuation Analysis for Home Mortgage Insurance for Single Family One-to-Four Unit Dwellings. The new appraisal guidelines were effective on August 1, 1999. Because the M&M contracts require the use of FHA-approved appraisers and compliance with standard guidelines, the appraisals obtained by the M&M contractors are required to adhere to current Departmental requirements. As a result, capturing the "as repaired" value was discontinued on August 1, 1999. After that date, appraisals included the "over or under \$5,000" estimate described above, purely for the purpose of identifying properties eligible for FHA-insured financing.

Staff do spend a great deal of time reviewing nonprofits' annual reports to ensure compliance with the 110% net development cost limitation. Nonprofits must submit all invoices associated with rehabilitation, as well as HUD-1 settlement statements for the purchase and resale of the properties and other documentation to prove the development costs are both eligible and legitimate. Staff input the documented information into an automated calculator, which generates a figure for the maximum resale amount for which the nonprofit can resell the property.

Subpart 5: FHA should strengthen the monitoring process by: conducting public records checks on nonprofit organizations' principals and involved rehabilitation contractors, realtors, and lenders.

FHA agrees that staff should conduct public records background checks on the nonprofit organizations and their principals, on rehabilitation contractors, realtors, and lenders. Currently, FHA staff use several data sources to research the relationship between members of the nonprofit and personnel from for-profit entities. In particular, reviewers look for connections between the nonprofit and for-profit businesses that employ or are owned by key staff, directors, or officers of the nonprofits. Also, staff research professional relationships via automated technologies such as ChoicePoint, States' web sites for license information, County recorder web sites, and the Guidestar website, which

contains information on nonprofit organizations' operations and finances. An additional enhancement is a database that lists the names of individuals and entities working with FHA-approved nonprofits. FHA staff will access this database to research potential conflicts of interest between for-profit groups and nonprofits.

FHA will issue additional guidance to lenders and nonprofits describing how FHA defines and prohibits identity of interest relationships. This guidance will be included in a mortgagee letter that will be published in the first quarter of FY2002.

Subpart 6: FHA should strengthen the monitoring process by: adopting methods to provide consistency between the HOCs in the determination of net development costs and corresponding profits on nonprofits' property resales.

FHA will be issuing guidance to all approved mortgagees and nonprofits on the calculation of net development costs. In addition, FHA will require all HOCs to use a standard automated software program to verify net development costs. This guidance will be issued during the first quarter of FY 2002.

Subpart 7: FHA should strengthen the monitoring process by: providing detailed training to staff on procedures to be used when performing reviews of annual reports and biannual recertifications.

FHA conducted such training in August 2001 and will continue to provide ongoing training as needed.

1C. Establish Specific Sanction Procedures to Recall Excess Profits

This recommendation has three subparts. FHA will respond in order of the subparts.

Subpart 1: FHA should establish specific procedures to ensure that, when appropriate, individuals and organizations that abuse the program are sanctioned and excess profits are returned.

FHA agrees that abusive nonprofits must be sanctioned. Currently, if a nonprofit has violated the net development cost limitation, FHA removes the nonprofit's approval to participate in the program. FHA will be issuing guidance to all approved mortgagees and nonprofits on the calculation of net development costs. This guidance will inform nonprofits that they will be required to return excess profits to FHA. These instructions will be issued during the first quarter of FY 2002.

Subpart 2: FHA should establish specific procedures to take action to seek reimbursement of excess profits from those nonprofit organizations that have previously been identified during the monitoring and recertification process.

FHA has no authority to establish this type of retroactive requirement; there are no regulations nor mortgagee letters in effect that state such a requirement. Mortgagee Letter 97-5, cited by OIG, refers to the responsibilities of the lender to collect excess profits *if* the same lender is responsible for the mortgage on the purchase *and* the resale. ML 97-5 does not require the nonprofit to pay back excessive profits to FHA.

As mentioned above, FHA has a Mortgagee Letter in clearance that clarifies the net development cost requirements for the properties purchased at the 30% discount level and informs nonprofits that they will be required to return excess profits to FHA. This mortgagee letter will address program risks, as identified by FHA, and will clearly provide FHA with the ability to institute enforcement measures against nonprofits that violate restrictions. Once the new mortgagee letter is published, FHA will begin the new practice for all agencies approved on or after the ML publication date.

Subpart 3: FHA should establish specific procedures to take administrative actions against those organizations and individuals who were previously identified as having violated program requirements.

FHA believes that this recommendation is consistent with current practice. FHA will continue to remove nonprofits that have violated program guidelines and pursue all feasible administrative actions to penalize abusive nonprofits and prohibit them from participating in the program.

1 D. Revise Requirements for Shallow Discount Properties

FHA should revise requirements to specifically require that properties sold to nonprofit organizations at a discount of 15 percent or less be sold to low and moderate income homebuyers at no more than 110 percent of net development cost.

FHA agrees that properties sold to nonprofits at a discount of 15 or 10 percent should be subject to the same limitations as the 30 percent, or "deep discount," properties. FHA will issue instructions that will establish these new restrictions. The mortgagee letter will establish a 110 percent net development cost limitation and 115 percent median income resale restriction for the "shallow discount" properties. Once the mortgagee letter is issued, all discounted properties will be sold with a land use restriction addendum attached to the sales contract to institute the restrictions. These instructions will be issued during the first quarter of FY 2002.

1 E. Change Bid Acceptance Requirements

FHA should change its requirements to require that when an owner-occupant submits a bid higher than the nonprofits' net bid after their discount, the owner-occupant homebuyer be awarded the property.

FHA concurs with this recommendation. It should be noted, however, that FHA does not believe that this change would result in a noticeable increase in instances where

owner-occupants obtained the property instead of the nonprofit organization. This is due primarily to the financing/closing cost assistance provided to owner-occupant purchasers, which lowers their net bid.

In conjunction with sales to individual owner-occupants, the Department may be requested to pay up to five percent towards their financing and/or closing costs and up to six percent towards the sales commission to the successful selling broker. Because HUD does not generally pay any of these charges in conjunction with nonprofit discount sales, the net offer from the owner-occupant buyer may be lower than the nonprofit organization's offer, although the gross offers were about the same. To further illustrate this point, the following example is provided:

Listing price is \$50,000	
Buyer 1 (owner-occupant): Offer price:	\$49,000
Financing & closing costs (5%):	\$ 2,450
Sales Commission (6%):	\$ 2,940
Net Offer	\$43,610
Buyer 2 (nonprofit): Offer Price:	\$48,500
10% discount:	\$ 4,850
Net Offer:	\$43,650

While this example does not represent all discounted sales, it does demonstrate that the nonprofit offer can and at times does result in a higher net return to the Department.

1F. Re-evaluate 10 Percent Discount Sales Program

FHA should re-evaluate the necessity and effectiveness of the 10 percent discount sales program for properties that require little or no repairs, and discontinue the program, if warranted

At present, FHA believes that the 10 percent discount serves several public purposes. A major component of all of the discount sales programs is the commitment by the nonprofit organizations to provide an affordable housing program as part of its reinvestment into the community it serves. The community investment and affordable housing component are, in our judgment, worth a 10 percent discount, because these factors add additional value to a HUD home sale. Moreover, the new mortgagee letter (referred to above) will limit profits and require resales to low- and moderate-income families, consistent with the requirements of the deep discount sales.

2A. Instruct HOCs on Calculation of Homeownership Rate

FHA should provide instructions to the HOCs relating to the computation of the single family homeownership rate for proposed revitalization areas including the exclusion of multifamily units from the computation and guidelines on what constitutes “substantially below.”

FHA agrees with this response. Instructions will be provided to the HOCs confirming the appropriate method to compute this rate.

The OIG report suggests that FHA’s calculation of homeownership rate should be a *single family* homeownership rate. However, the authorizing Act, Section 602 of the HUD 1999 Appropriations Act, does not define the term “homeownership rate.” The Act only requires that “low homeownership rate” be one of the criteria for designation of revitalization areas.

FHA believes that the use of the *overall* homeownership rate is a more appropriate measure to establish revitalization areas. One of the primary objectives of the 30 percent discount sales is to expand homeownership opportunities for families who are not currently homeowners and who may not be able to purchase homes otherwise.

HUD’s Homeownership Centers will be instructed to use the U.S. Bureau of the Census definition found in the Housing Vacancy Survey (4th Quarter) 2000 Definitions and Explanations. The definition says:

Homeownership Rates. The proportion of households that are owners is termed the “homeownership rate.” It is computed by dividing the number of households that are owners by the total number of households. The formula is as follows:

$$\text{Homeownership Rate} = \frac{\text{Owner Households}}{\text{Total Occupied Households}}$$

The above calculation satisfies the requirements of Housing Notice H-00-16.

2B. Implement Controls on Revitalization Areas

FHA should implement controls to periodically test for sales outside revitalization area zip codes by matching the zip codes for all 30% sales during the period against the list of current revitalization area zip codes.

FHA agrees that new controls are needed to better ensure that 30 percent discounted sales do not occur outside of revitalization areas. FHA has developed a monthly report which is pulled from SAMS that allows HUD to review **all** discounted sales to determine 1) that nonprofit organizations are not exceeding their purchase limitations and 2) that sales to approved nonprofit organizations are occurring only in the areas in which they are approved to participate. This report also identifies any sale

outside of a revitalization area. This report will be shared with the HOCs and instructions will be provided to further ensure that discounted sales are actively monitored on a monthly basis.

With regard to sales outside of revitalization areas, to date, a comprehensive review has found that HUD's M&M contractors have sold properties outside of established revitalization areas and we have taken steps to recover the loss to the mortgage insurance fund. During the period of your review, HUD sold 15,198 properties in revitalization areas. The Santa Ana HOC has identified 35 property sales outside of revitalization areas for which the M&M contractors were responsible and has issued demand letters totaling approximately \$1 million. The Atlanta HOC has identified 48 property sales outside of revitalization areas and has issued demand letters totaling approximately \$550,000. Data entry within SAMS by both HUD personnel and M&M contractor staff are related to the additional discrepancies noted in your report. These errors will be corrected.

We believe that the revitalization area-mapping project, which is expected to be completed by October 31, 2001, will substantially eliminate any confusion about revitalization areas. Through this project, Housing will be able to utilize an on-line service to confirm if any property identified anywhere in the country is inside or outside a revitalization area. Although all HOCs are presently reviewing approved revitalization areas on a periodic basis, HUD will issue specific guidelines establishing the timeframes to complete this review. These guidelines will be issued in a future update to Housing Notice H-00-16.

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