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TO: Nicholas P. Retsinas, Assistant Secretary for Housing-Federal
Housing Commissioner, H

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

SUBJECT: Audit of Section 203(k) Rehabilitation Mortgage Insurance Program¹

We completed an audit of the Section 203(k) Rehabilitation Mortgage Insurance Program as it pertains to investor and non-profit borrowers. This report includes two findings, one of which we previously reported to you in our interim Audit-related Memorandum 96-AT-221-1823 dated July 15, 1996.

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.

We appreciate the cooperation and input of the Office of Housing during this audit. Should you or your staff have any questions, please contact me at (404) 331-3369, or Bruce Milligan, Senior Auditor, at (910) 547-4056.

¹ This version of the 203(k) audit report does not contain any graphics or photos. Also, Appendices D and E are not included in this version. For a complete copy of this audit, please request a copy from the Office of Audit, Southeast/Caribbean District.

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Executive Summary

We audited the Section 203(k) Rehabilitation Mortgage Insurance Program as it pertains to investor and non-profit borrowers. Our objective was to determine if the 203(k) Rehabilitation Mortgage Insurance Program promotes and facilitates the restoration and preservation of existing housing in an effective, efficient, and economical manner. We reviewed 442 loans made by 8 lenders to 74 investor and non-profit borrowers.

Our review disclosed that: (1) the 203(k) Program is highly vulnerable to waste, fraud, and abuse by investors and non-profit borrowers, and (2) the escrow commitment procedure increases the amount of certain loans beyond statutory limits.

Loans to investors and non-profits constitute unreasonable risk

The 203(k) Program is highly vulnerable to waste, fraud, and abuse by investors and non-profit borrowers. The program design encourages risky property deals, land sale and refinance schemes, overstated property appraisals, and phony or excessive fees, and does not adequately safeguard Department of Housing and Urban Development's (HUD) interests. Moreover, participation by investors and non-profits does not appear to promote HUD's objective -- to restore and preserve existing housing in an effective, efficient, and economical manner. The abuses have not been isolated to any one person, group, or area of the country. As demonstrated by our examples, this program seems to be viewed by some as merely a means to turn a quick profit.

Our results show that non-profit and investor borrowers have carried out fraudulent or otherwise unnecessary land and refinance transactions to generate money for either the borrower or identity-of-interest parties. They have not made required downpayments. They have obtained loans on properties which did not need significant repairs and should not have been in the program. Investors have been paid for rehabilitation work that was not performed. Non-profit borrowers have obtained large numbers of loans and have been unable to complete the work. Non-profit borrowers have also made large profits, contrary to their stated motivation. Unfortunately, mortgage lenders have contributed to the abuse. One large lender, for example, repeatedly circumvented HUD loan origination requirements to assist otherwise unqualified borrowers in obtaining loans and charged ineligible and unsupported fees.

The involvement of investors and non-profit organizations in the 203(k) Loan Program unnecessarily increases HUD's risk of loss to the insurance fund from defaults. Of the loans we reviewed, too few homes had been properly rehabilitated and timely occupied. In addition, we computed excessive profits and ineligible fees totaling about \$4.5 million in 344 loans -- a cost ultimately passed on to a homeowner or to HUD and the taxpayer in the case of a default. We believe that HUD should immediately disqualify investors just as it has done in the 203(b) Loan Program and take other precautions to prevent the program abuse that is occurring.

Loans Exceeded Statutory Limit

HUD has endorsed loans to investors and non-profit borrowers which exceed the loan limit in the authorizing legislation for the 203(k) Program. The problem occurred when HUD implemented the escrow commitment procedure for computing loans. The escrow commitment procedure increases the amount of the HUD insured loan and allows speculation of future property value. HUD learned of its error about August 1, 1996 but did not stop the lenders from using the procedure. Since 1991, HUD endorsed for insurance about 6,770 loans to investors and non-profit borrowers. Most of these loans were computed using the escrow commitment procedure. The Housing staff told us they plan to request a change in the law to allow the procedure. We recommend that HUD suspend the procedure until and unless the law is changed.

Response to Interim and Draft Final Reports

The Assistant Secretary responded to our interim report by memorandum of September 30, 1996 (see Appendix D). The Assistant Secretary agreed with most of the proposed audit recommendations for Finding 1 and stated that they would be implemented. The Assistant Secretary's staff quickly began work to determine how best to implement improvements to address the issues in the audit. On October 29, 1996, the Assistant Secretary notified mortgagees that HUD had placed a moratorium on investor loans. The Assistant Secretary disagreed with three recommendations. We revised one of the recommendations and have included comments in Finding 1 explaining why the other two recommendations should be implemented. By memorandum of January 14, 1997, the Deputy Assistant Secretary for Single Family Housing responded to the draft final report (see Appendix E). The Deputy Assistant Secretary stated her staff was studying ways to improve the 203(k) Program, and, when their conclusions were complete, they would meet with the OIG to discuss the results of their work. In regard to the escrow commitment procedure, the Deputy Assistant Secretary stated the issue was being reviewed with the Office of General Counsel.

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Abbreviations

- CFR - Code of Federal Regulations
- HUD - U. S. Department of Housing and Urban Development

Introduction

Background

Section 203(k) loans were authorized by Section 101(c)(1) of the Housing and Community Development Amendments of 1978 (Public Law 95-557) which amended Section 203(k) of the National Housing Act. The program objective is to enable HUD to promote and facilitate the restoration and preservation of the Nation's existing housing stock. The 203(k) Program is regulated in Title 24 of the Code of Federal Regulations (CFR), part 203.50 and parts 203.440 through 203.495. Additional requirements are included in the 203(k) Handbook 4240.4 REV-2, *Rehabilitation Home Mortgage Insurance*, and various Mortgage Letters issued by HUD.

From October 1, 1985 through September 30, 1996, HUD endorsed for insurance 40,389 loans under 203(k). The loans totaled about \$3.1 billion; \$1.5 billion in 1996 alone. Recently, HUD began vigorously promoting the 203(k) Program. The number of loan originations increased significantly from an average of 437 in fiscal years 1986 through 1990 to an average of 3,093 in fiscal years 1991 through 1994, to 8,399 in 1995 and about 17,000 in 1996. The claim/default rate for all 203(k) loans originated in the 8 year period ended December 31, 1995, was 5.1 percent for all types of borrowers. The rate for loans to investors and non-profits was 8.6 percent.

The Section 203(k) Program is administered by the Office of Insured Single Family Housing within HUD's Office of Housing.

The Secretary's Performance Report for fiscal year 1996 included a management plan for the Section 203(k) Program. The plan provided that the Secretary's priority was to make homeownership a reality for more Americans and that the commitment was to expand homeownership opportunities for more Americans. The plan included the goal of endorsing 7,506 Section 203(k) loans. HUD exceeded its goal for fiscal year 1996 by endorsing about 17,000 Section 203(k) loans.

Audit Objectives, Scope, and Methodology

Our objective was to determine if the 203(k) Rehabilitation Mortgage Insurance Program promotes and facilitates the restoration and preservation of existing housing in an effective, efficient, and economical manner. Our review included only loans to investor and non-profit borrowers.

The lenders and loans we reviewed are listed in Appendix A. We selected our sample to include loans throughout the country by high volume lenders made to borrowers obtaining multiple loans. Our sample included both current loans and loans in default. In some cases there were known problems in the origination of the loans when we made our selections and in some cases there were no known problems. At each lender, we interviewed key staff to determine the lender's administrative controls over the program. We reviewed the loan origination file for a sample of loans. On a test basis, we examined the closing agent's records and verified the receipt and disbursement of the funds at loan closing. In some cases we verified loan data with the borrower, the seller of the property, and the holder of any existing debt. We inspected a sample of the properties and examined the disbursement records for the rehabilitation escrow account and supporting documentation. In some cases we

determined if the property was occupied by a homeowner or lessee and the mortgage status of the loans. All samples were judgmentally selected.

We also reviewed reports of monitoring work for the 203(k) Program performed by the HUD Office of Lender Activities. These reviews are also listed in Appendix A.

Our audit generally covered the period July 1, 1993 through August 31, 1996. We performed the audit July 1995 through September 1996. The audit was conducted in accordance with generally accepted government auditing standards.

Loans to Investors and Non-Profits Constitute Unreasonable Risk

Section 203(k) loans to investors and non-profit organizations constitute unreasonable risk to the Federal Housing Agency insurance fund. Our results show that these types of borrowers have obtained HUD-insured loans which fail to meet HUD requirements, fail to meet prudent lending practices, and are clear indications of program abuse. We identified:

- ⊞ Land sale schemes intended to turn quick profits between identity-of-interest parties.
- ⊞ Refinance schemes intended to provide quick profits to borrowers.
- ⊞ Borrowers failing to make downpayments necessary to guarantee their commitment.
- ⊞ Rehabilitation work not completed or improperly performed.
- ⊞ Properties were overvalued.
- ⊞ Profits to non-profit organizations.
- ⊞ Rehabilitation loans made on properties which needed only minor maintenance.
- ⊞ Higher loan defaults and forced refinances.
- ⊞ Ineligible and unsupported fees.

These cases are not isolated. Together with the results from the Office of Lender Activities, our reviews span the activities of 67 investors and 7 non-profits receiving 442 loans from 8 different lenders throughout 10 states. Of the 442 loans reviewed, we found 1 or more of the above problems in 406. Unless some immediate action is taken, we predict substantial future losses to the Federal Housing Agency fund from or because of these type of borrowers.

(Map - see footnote 1)

Widespread program abuse

This report describes cases of fraud and program abuse by non-profit and investor borrowers participating in the 203(k) Program. Our results coincide with results of reviews conducted by the Office of Lender Activities.

Land sale schemes

Borrowers on 27 loans in Georgia, 133 loans in Florida, 6 loans in Michigan, 5 loans in Ohio, 6 loans in North Carolina, 28 loans in Virginia, and 17 loans in California participated in fraudulent and unnecessary land transactions for the sole purpose of generating immediate cash profits for either the borrower or identity-of-interest parties. These schemes netted the parties millions with no value added while unnecessarily putting HUD at risk. The parties inflated property sales prices which increased the loan amounts. This allowed the borrowers to realize profits at loan closing instead of after the property was repaired and sold. It also takes away the borrower's incentive to ensure the rehabilitation is properly completed.

The following chart (see footnote 1) illustrates the exorbitant profits made on property deals in Georgia and Florida.

(Pie Chart)

Details of these land schemes follow:

An investor purchased and immediately sold 27 properties in Georgia turning a quick and illegal profit of over \$1 million. The loans were closed in Virginia and, according to HUD's Virginia Office, the price paid by the borrower could not exceed the price paid by the seller if the seller had acquired the properties within 1 year of the closing of the HUD-insured loans. In this case, the investor had acquired 23 properties on the same day of closing the 203(k) loans and within 3 months of closing the others. Therefore, the investor, who had an identity-of-interest with at least 19 and possibly all of the 27 borrowers, falsified the HUD-1 Settlement Statement to show that it had paid \$123,000 for each of the properties. The investor actually paid \$80,893 per property and took a profit of \$1,136,889 with minimal investment or risk. This scheme increased HUD's risk by \$35,800 per property. The four individuals in this investor partnership agreed to a 5 year suspension from doing business with HUD.

For 67 loans in Florida, a lender, a non-profit borrower, and another non-profit group represented by an official of the rehabilitation contractor, joined in a phony land transaction which unnecessarily increased the HUD-insured loans by about \$328,000. The HUD-1's showed the non-profit borrower paid the non-profit group \$596,530 for the properties. Each HUD-1 was falsified. At the time, the borrower had already agreed to purchase the properties from the

Federal Home Loan Mortgage Corporation (Freddie Mac) for only \$250,000. At closing, loan proceeds of \$219,573 (sales price of \$250,000 less downpayment and settlement charges) were actually paid to Freddie Mac and nothing was paid to the non-profit group. As the following chart shows, the borrower did not make the required downpayment (falsely stated as \$167,098) and the lender took \$179,432 in cash at closing.²

HUD-1 PART	DESCRIPTION	PER HUD-1's	PER CLOSING AGENT RECORDS	PER HUD RULES ³
101	Contract Sales Price	\$596,530	\$250,000	\$250,000
103	Settlement Charges to Borrower	\$1,574,812	\$1,574,812	\$1,574,812
120	Gross Amount Due From Borrower	\$2,171,342	\$1,824,812	\$1,824,812
202	Principal Amount of New Loan	\$2,001,250	\$2,001,250	\$1,654,720
207	Prepaid Interest Credit	\$2,994	\$2,994	\$2,994
220	Total Paid By/For Borrower	\$2,004,244	\$2,004,244	\$1,657,714
303	Cash From Borrower	\$167,098		\$167,098
	Cash To Borrower		\$179,432	

Another non-profit borrower bought 52 properties through the same lender in Florida for \$1,248,000, netting the parties to the transaction a profit of \$533,000. The seller, who had been disapproved by HUD to participate in this program, had acquired the properties on or about the same day for \$715,000. Contrary to HUD requirements, the president of the non-profit borrower also served as the closing agent for the HUD-insured loans. About 4 weeks after closing, the borrower deeded the 52 properties back to the seller. About 2 weeks after that, and without HUD approval, the lender filed a document releasing the borrower from liability for the mortgages. The same parties were involved in 14 additional loans which were closed following similar procedures. The 14 loans included improper land profits of \$226,350. Sixty-five of the total 66 loans were in default.

A non-profit borrower obtained 11 loans in Michigan and Ohio on properties it bought from HUD at discounted prices. Each HUD-1 falsely showed the purchase price to be the HUD list price before the discount. As a result, the loans provided excess funds of \$98,420. The non-profit borrower used \$15,762 for its required investment and received the remaining \$82,658 in

² See Audit Report 96-AT-221-1004, Waters Mortgage Corporation, dated May 13, 1996, for additional information.

³ This column shows how the loan should have been closed following HUD requirements.

cash at the loan closings. The lender for nine of the loans had an identity-of-interest with the non-profit borrower.

An investor purchased nine rental properties from a single seller. The properties were at the same location, were of the same design, and were in substantially the same maintenance condition. The investor obtained 203(k) loans on 6 properties and paid the seller \$62,500 for each property. The investor did not obtain 203(k) loans for the other 3 properties and paid only \$17,333 for each property. By not averaging the price paid for all 9 properties, the 6 HUD-insured properties were overvalued by \$90,333 and the loans were inflated by \$76,782. The loans went into default.

Two other land schemes netted investors in Virginia \$560,000 and a non-profit borrower \$260,057 in California.

Refinance schemes

For 18 loans, 3 investors and a non-profit obtained loan proceeds of \$754,463 through improper refinance transactions.

In Massachusetts, an investor received two loans to pay off outstanding debts of \$220,440 on two properties. However, the debts did not exist, and the \$220,440 was paid to a company owned by the investor. A lien payment of \$135,390 on a third loan was not properly supported.

In California, eight loans to an investor provided for pay off of the first mortgage on properties which the investor had purchased about six months earlier. The loans also included \$350,000 to pay off second and third mortgages for money the investor claimed to have borrowed on the properties. The lender did not obtain documentation that the subordinate mortgages existed or that the borrower used the \$350,000 to improve the properties. Consequently, the second and third liens should not have not been included in the 203(k) loans.

For two loans in Illinois, the lender incorrectly based the loans on the as-is property value. The non-profit borrower had no debt on one property, and the debt on the other property was less than the as-is value. As a result, the non-profit improperly received \$32,844 from the loan proceeds.

Five loans in Georgia included \$15,789 to pay off a debt, but the funds were not used for that purpose.

Borrower downpayments not made

Despite the borrowers' signed statements to the contrary, we documented 96 loans where non-profit and investor borrowers did not make downpayments as required. When a borrower has no investment at risk, HUD's risk becomes greater.

The following are examples:

A non-profit borrower failed to make downpayments on 79 Florida loans totaling \$198,766.

An investor in North Carolina did not make downpayments of \$44,000 on 6 loans from its own resources. Instead, the father of the seller of the property put up \$44,000 for the borrower's downpayments.

To make the downpayments for 6 loans, an investor in California borrowed \$96,114 from the lender. The lender disbursed the \$96,114 from the rehabilitation escrow and escrow commitment accounts of 2 other 203(k) loans for the same investor. All eight loans went into default.

An investor in Georgia obtained five loans to refinance existing debt and rehabilitate the properties. At loan closing, proceeds of \$15,789, which were supposed to be used to pay off the borrower's existing debt, were instead used for the borrower's downpayments.

Rehabilitation work not properly performed

In 170 cases, investor and non-profit borrowers failed to properly complete the rehabilitation work funded by the 203(k) loans. Some non-profits have attempted to restore too many properties at once. Lenders, whose responsibility it is to ensure timely and proper completion of rehab, have also failed to perform. The probability of loan default greatly increases when rehabilitation work stalls.

Listed are some of the cases found:

For 43 loans in Illinois, a lender certified that the rehabilitation work was completed and released the rehabilitation escrow funds. The Office of Lender Activities subsequently determined that, for 12 properties, little or no work was performed. For the rest, substantial portions of the scheduled work had not been performed.

An investor obtained five loans in Georgia in December 1994 but did not complete the property rehabilitation. The lender disbursed \$10,831 from the rehabilitation escrow for work which was certified as completed. We confirmed that it was never performed. The loans went into default after only four mortgage payments. The two pictures below (see footnote 1) show the condition of these properties as of April 1996.

(Two pictures - Georgia)

The next two pictures (see footnote 1) are of multi-unit properties abandoned by an investor in North Carolina who did not complete the rehabilitation. He defaulted on the six loans after making only six payments. The borrower tried to perform as the general contractor but apparently did not have the capability to complete the job. The loans closed in the fall of 1993. These pictures were taken in March 1996.

(Two pictures - North Carolina)

A non-profit borrower in Florida had loans for 107 properties under rehabilitation at one time. The borrower failed to timely complete the rehabilitation work for 95 properties and the loans went into default. We believe the borrower lacked the managerial capability. The files showed the borrower did not have the financial capacity to carry the loans. So, the borrower transferred the 95 properties to a second non-profit borrower. The second borrower assumed 51 of the loans but obtained new 203(k) loans for the other 44. The 44 new loans included more money for rehab and exceeded the original loans by \$218,500. Over 23 months after closing these 95 loans, the rehabilitation of 40 properties was still not complete.

An investor in Massachusetts used an identity-of-interest company to perform the rehabilitation work for eight properties. The investor received rehabilitation draws of \$112,698 but could support expenditures for rehabilitation work of only \$52,303, a difference of \$60,395. Based on our property inspections and file reviews, it appeared that some of the items included in the work write-ups were not performed and that other parts of the work were completed before the 203(k) loan was originated.

For 13 loans in Georgia, a non-profit borrower and the lender's inspector certified that the rehabilitation work was properly completed. The lender disbursed the rehabilitation escrow funds to the contractor. However, our inspections showed that all 13 properties had work which was not completed, and 6 properties had work which was overpriced. Payments for work not performed totaled \$42,069. Excessive payments for overpriced work totaled \$19,050.

Properties were overvalued

The Office of Lender Activities reviewed 61 loans in Illinois and found that the appraised value of 50 of the properties was substantially overstated. The overstatements ranged from \$5,500 to \$71,000 and averaged \$24,520. The loans were inflated to provide excess rehabilitation escrow funds which the lender then disbursed for work which was not performed.

Overstated appraisals increase HUD's risk from defaults because the higher loans make it more difficult for borrowers to sell the properties by assumption or to lease them at high enough rents to pay the note. Overstated appraisals facilitate the land sale and refinance schemes, excessive rehabilitation, and unnecessary fees.

Excess profits by non-profit borrowers

Some loans included what we considered to be excessive profits for non-profit borrowers. Through the 203(k) escrow commitment procedure, loans may include amounts set aside as profit for the borrower. The escrow is released after the property is rehabilitated and transferred to a new buyer. These profits increase HUD's risk by raising the loan amount and the cost of the housing.

We found several examples of generous profits:

A non-profit borrower in Texas obtained 37 loans between April and September 1995. The loans included escrow commitments of \$533,250, an average of \$14,412 per loan. As the chart (see footnote 1) illustrates, the average commitment was 21 percent of the loan amount; the highest commitment was 42 percent of the loan total. The escrow commitment amounts almost equaled the cost for rehab.

(Chart - see footnote 1)

In Georgia, a non-profit borrower obtained 21 loans from March through August 1995. Fifteen of the loans included escrow commitments totaling \$99,850. The commitments for 10 of the loans exceeded 10 percent of the loan amount, averaged 18 percent, and ranged from 10.5 to 29.4 percent.

A non-profit borrower in Illinois obtained 13 loans in March 1995. The loans included escrow commitments totaling \$98,427, the highest being 28.5 percent of the loan amount.

Significant rehabilitation not needed

Investor and non-profit borrowers have obtained 203(k) loans on properties that did not need significant rehabilitation. Some properties barely qualified. These loans increased HUD's risk and did nothing to meet the program objective to improve the Nation's existing housing stock.

In Georgia, an investor's rehabilitation of 24 properties, all duplex units, averaged only \$6,287 and ranged from \$5,744 to \$6,798. This barely exceeded the program minimum of \$5,000. Inspections and interviews of occupants of a sample of units revealed that: (1) much of the work in the write-ups appeared unnecessary, (2) some work was over priced, and (3) some work planned was not completed. The units are part of the 27 loans previously described where the seller inflated the sales prices by \$1,136,889. We concluded that the units did not need rehabilitation and were in the program solely to enable the seller to profit on the land sale transactions.

A non-profit borrower in Texas obtained nine loans for properties which did not need significant rehabilitation work. The borrower purchased the properties from HUD. We found HUD appraisals for six of the properties showing that none of them needed repairs to meet minimum property standards. Two of the nine properties did not include the minimum \$5,000 of eligible repairs. The other seven loans met the \$5,000 requirement only because the rehabilitation work

included cosmetic items. As an example, the home pictured below (see footnote 1) was only 3 years old when the 203(k) loan was approved and did not need significant rehabilitation work.

(Picture - see footnote 1)

An investor in Massachusetts obtained three loans on ineligible properties. One loan was on a fraternity house that included more than four rental units. The other two units did not need significant rehabilitation work, and the investor spent less than \$5,000 to complete the work which was performed.

Equity skimming

We found three cases of equity skimming by investors and non-profit borrowers whereby the borrower profited from the properties but did not pay the mortgage. An investor in North Carolina received Section 8 payments of \$8,266 for three rented units for a 16 month period but did not make the mortgage payments to the lender. The president and two employees of a non-profit borrower in California lived in three houses for which the borrower obtained 203(k) loans. Neither the president, the employees, nor the borrower made the mortgage payments for the three loans. We also obtained information on a case of equity skimming in New York. An investor with 10 loans received Section 8 payments of \$28,968 which were not used to cure the loan delinquencies. The loans were delinquent for 8 monthly payments totaling \$20,403, and were in foreclosure.

Ineligible and unsupported fees included in the loans

Two lenders approved ineligible and unsupported fees of \$90,755 for 191 loans. The discrepancies were in charges for consultants, property inspections, building permits, surveys, and document preparation. A lender approved ineligible and unsupported fees of \$70,551 for 182 loans in Florida and Georgia. The \$70,551 included \$13,600 paid to the lender, \$15,364 paid to a borrower, and \$41,587 paid to contractors. Nine loans in California included ineligible fees of \$20,204 which were paid to the lender.

Reasons for program abuse

The 203(k) Program is vulnerable to program abuse from investor and non-profit borrowers for several reasons.

Profit Motive - Investors participate for the profit; however, the prospect of undetected excess returns leads some to commit fraud. HUD experienced problems with investors participating in the Single Family Mortgage Insurance Program and in December 1989 prohibited them from

obtaining most HUD-insured single family loans. HUD did not apply the prohibition to the 203(k) loan program.

It also appears that some non-profit borrowers do not have as their primary objective the goal of serving low and moderate income families or of community revitalization. Instead, they have committed the same abuses as investors to generate unreasonable profits for themselves. To illustrate this point, for the first 5 months of 1996, the president of a non-profit borrower in our review received \$248,398 in salary and bonuses from the non-profit borrower and an additional \$150,464 in salary and commissions from a lender. The lender had an identity-of-interest with the borrower and approved 203(k) loans for the borrower.

Program design flaws - The design of the 203(k) Program is risky with incentives and opportunities for abuse. Although small in volume compared to HUD's 203(b) Single Family Program, these loans represent a significant risk to HUD.

HUD relies heavily on the lenders to ensure loans are originated according to program requirements, yet the prospect of earning the large fees allowed by this program can and has enticed lenders to break the rules. All loans we reviewed were originated by direct endorsement. In many cases, the lenders performed the work write-up and cost estimate, appraisal, and rehabilitation inspections with in-house staff. This earned the lenders fees and allowed them control over most of the loan processing steps. These loans also include higher interest rates and origination fees than HUD's 203(b) loans. In some of our cases, the lenders approved loans even though they knew or should have known the loans did not meet HUD requirements.

A 203(k) loan can be as high as 110 percent of the after rehabilitation appraised value. A property encumbered by a loan that exceeds the property's value is more difficult for an investor or non-profit borrower to sell by loan assumption under the escrow commitment procedure. Thus, HUD's risk of loss increases.

The program allows the borrower to serve as the general rehabilitation contractor regardless of experience. Some borrowers did not appear to have the skills needed to perform in that capacity.

As described in Appendix B, there are many steps in the 203(k) loan process. All are critical and must be properly performed for a successful loan. Failure in any one area can result in a loan default.

Adverse effects of increased insurance risk

HUD's Office of Insured Single Family Housing did not obtain default data on 203(k) investor and non-profit borrower loans. However, we obtained data which shows that the rate was 8.6 percent for loans originated in the 8 years ended December 31, 1995. This is 3.5 percent higher than the overall rate for the 203(k) Program and about 5.5 percent higher than the 203(b) Program. It is also likely that the 203(k) default rate is understated because: (1) there was a large increase in the number of loans originated in 1995, and (2) loans are being refinanced as new 203(k) or as 203(b) loans. Without analysis of that data, HUD cannot adequately evaluate the overall performance of the program or target individual lenders or borrowers for review.

In view of the extent of problems we were finding and the need for immediate corrective action, we issued an interim report to the Assistant Secretary for Housing - Federal Housing Commissioner on July 15, 1996 (Audit Related Memorandum 96-AT-221-1823) with eight recommendations for improvements to the program.

Steps HUD has taken

Prior to our interim report, the Office of Housing took steps to strengthen program controls to prevent some of the abuses we and they had seen. Mortgagee Letter 95-40 dated September 13, 1995, added procedures designed to: (1) prevent land sales schemes (2) require HUD approval of non-profit borrowers, and (3) improve lenders' reviews of financial capacity of non-profit borrowers. In Mortgagee Letter 96-18 dated April 16, 1996, HUD prohibited non-profit borrowers from assuming loans which had been closed using the escrow commitment procedure.

In Mortgagee Letter 96-52 dated September 19, 1996, HUD added procedures to: (1) improve the effectiveness of lenders' reviews of non-profit borrowers' financial and management capacity, and (2) better track non-profit borrower loans in HUD's data system. Also, the Office of Lender Activities reviewed several lenders to document program abuses and recommend sanctions to the Mortgagee Review Board. The Board has imposed sanctions against five lenders; sanctions are pending against two more.

Response to interim report

By memorandum of September 30, 1996, the Assistant Secretary responded to our interim report and recommendations (see Appendix D-see footnote 1). The Assistant Secretary initially did not agree with our recommendation (1A) to prohibit investor participation in the 203(k) Program. Instead, he proposed to implement additional controls to limit the number of loans, increase HUD's field review of after-rehab appraisals, and improve HUD's computerized database of claim and default data

However, on October 29, 1996, the Assistant Secretary reconsidered and issued Mortgagee Letter 96-59 notifying mortgagees that HUD had placed a moratorium on investor loans.

The Assistant Secretary indicated that our recommendation (1H) to obtain default data by borrower type had already been implemented. He agreed to add steps to prevent land sale schemes (1C) and release a letter informing lenders of program abuses and possible penalties and sanctions (1G). He indicated that HUD would continue to monitor loans to non-profit borrowers (1B), but would not add procedures due to HUD's staffing shortage.

The Assistant Secretary disagreed with three recommendations.

We recommended that HUD increase the minimum required rehabilitation work (1D). The Assistant Secretary considered the \$5,000 minimum to be sufficient, but proposed to issue further instructions to ensure the minimum included required repairs as opposed to cosmetic repairs and the property really needs rehabilitation. We concur and revised our recommendation.

We recommended that HUD limit the profit and overhead allowed in the escrow commitment for a non-profit borrower (1E). The Assistant Secretary disagreed saying HUD already had an effective limit on loans involving purchases of HUD properties. For others, the Assistant Secretary gave his analysis of why a limit under the escrow commitment procedure would not prevent high profits. We disagree with the Assistant Secretary's analysis because it assumes non-profit borrowers will choose loan alternatives which maximize profits to the non-profit borrower. The 203(k) Program should not support non-profit borrowers who have profit as their primary objective.

We recommended that borrowers be prohibited from serving as contractors unless they demonstrate sufficient construction experience (1F). The Assistant Secretary stated that Handbook 4240.4 REV-1, paragraph 3-2.D.3, already includes such a requirement and requires the lender to obtain documentation that the borrower is "competent to do the work." We believe the procedure should be strengthened to require the borrower to be a licensed contractor with housing construction experience.

By memorandum of January 14, 1997, the Deputy Assistant Secretary for Single Family Housing responded to our draft final report (see Appendix E-see footnote 1). The Deputy Assistant Secretary stated that the Single Family staff had hosted meetings with the 203(k) Investor Working Group in November 1996 and January 1997 to explore further policy reforms that HUD will implement to provide rehabilitated housing without abuse and risk to the insurance fund. The Deputy Assistant Secretary stated that her staff would discuss the results of the meetings with the OIG and take necessary steps to implement changes to the program.

Recommendations

The following recommendations reflect consideration of the Assistant Secretary's and Deputy Assistant Secretary's responses to the interim and final reports. If the Assistant Secretary acted on an interim recommendation, it has not been repeated. If he concurred with the interim recommendation but had not acted on it, it is repeated only for purposes of establishing an implementation date. We have also added or revised some of our original recommendations to be more specific, to address concerns expressed by HUD staff, or to address problems detected since issuing the interim report. In some cases, our recommendations remain unchanged.

We recommend that the Office of Housing:

- 1A. Prohibit investor participation in the 203(k) Program as HUD has previously done in other single family mortgage insurance programs.
- 1B. Limit the amount of reimbursement for overhead and profit for loans to non-profit borrowers. Alternatives might be to: (1) limit the escrow commitment (amount of potential profit) to a reasonable level, or (2) eliminate the escrow commitment procedure and allow a fixed fee.
- 1C. Take steps to prevent refinance schemes such as:
 - Require the lender to verify all debts to be paid from the loan and ensure that none were incurred to enable the borrower to obtain cash at loan closing.
 - Require the borrower to certify, over a warning notice, the interest of any identity-of-interest party in any debt to be retired from the loan proceeds.
 - Require the lender to verify that the loan proceeds are disbursed in the proper amount to the debt holder.
- 1D. Establish criteria for approving the borrower to act as the general contractor.
- 1E. Prohibit payments from the loan proceeds for contractor profit and overhead if the contractor is also the borrower or an identity-of-interest party, and require the contractor to maintain complete records for the rehabilitation cost.

We recommend the Office of Housing establish a timetable to:

- 1F. Monitor the effectiveness of the new procedures for HUD approval of non-profit borrowers and lender review of the non-profit borrowers' financial capacity, and decide whether to allow non-profits to continue to participate in the program.
- 1G. Limit the number of loans to an investor or non-profit borrower to 15 at any one time.

- 1H. Take further steps to prevent land sales schemes such as:
- Requiring an "as-is" appraisal for projects involving over seven loans.
 - Requiring the borrower to certify, over a warning notice, the interest of any identity-of-interest party in the seller of the property.
 - As part of the title process, requiring the lender to determine the chain of ownership of the property for 2 years prior to the loan to identify identity-of-interest transactions.
 - Requiring the lender to verify that the loan proceeds are disbursed in the proper amount to the property owner included on the loan application.
- 1I. Develop and implement procedures to ensure: (1) the \$5,000 minimum for rehabilitation work is made up of required repairs, as opposed to cosmetic repairs, and (2) the property really needs to be rehabilitated as described in the National Housing Act.
- 1J. Issue a Mortgagee Letter warning lenders of the program abuses that have been found, the penalties which may be imposed for such abuses, and HUD's intention to impose sanctions and refer abusers for criminal prosecution.

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Escrow Commitment Procedure Increased Loan Amounts Beyond Statutory Limits

HUD has endorsed loans to investors and non-profit borrowers which exceed the loan limit imposed by the authorizing legislation for the 203(k) Program. The problem occurred when HUD implemented the escrow commitment procedure for computing loans. The escrow commitment procedure increases the amount of the HUD insured loan and allows speculation of future property value. HUD learned of its error around August 1, 1996 but did not stop the lenders from using the procedure. Since 1991, HUD endorsed for insurance about 6,770 loans to investors and non-profit borrowers. Most of these loans probably were computed using the escrow commitment procedure.

Law requires

The National Housing Act, Public Law 95-557, Section 203(k), authorizing the program states, "...for purposes of this subsection, the Secretary shall establish as the appraised value of the property an amount not to exceed the sum of the estimated cost of rehabilitation and the Secretary's estimate of the value of the property before rehabilitation." In other words, the law limits the loan to the value of the property before rehabilitation plus the cost of rehabilitation. The limitation is also included in 24 CFR part 203.50(f)(1).

Conflict with law

Under the escrow commitment procedure in HUD Handbook 4240.4 REV- 2 Section 1-10A, HUD allows a 203(k) loan to be based on the appraised value of the property after rehabilitation subject to the loan-to-value ratio and maximum dollar amount limitations prescribed under Section 203(b) for a principal residence. The procedure is summarized in Appendix C. The purpose of the escrow commitment procedure is to facilitate the sale of the property after rehabilitation by loan assumption and thereby reduce the buyer's cash investment. The procedure can be used by investors and non-profit borrowers. The escrow commitment procedure violates the authorizing legislation because it permits the loan to exceed the value of the property before rehabilitation plus the cost of rehabilitation. For example:

- In Texas, a non-profit borrower obtained 37 loans under the escrow commitment procedure. The total loan amount using the escrow commitment was \$2,474,250. The statutory limit, however, was \$1,941,000 which represented the "as is" value of the property plus the cost of rehabilitation. Thus, HUD overinsured these 37 loans by \$533,250.
- In Chicago, a non-profit borrower obtained 13 loans under the escrow commitment procedure. The total loan amount was \$811,500. The statutory limit was \$713,073. Therefore, HUD insured these 13 loans by \$98,427 beyond its authority.

- In Atlanta, a non-profit borrower obtained 15 loans under the escrow commitment procedure. The total loan amount was \$707,200 but the statutory limit was only \$607,350. HUD overinsured these loans by \$99,850, an average of \$6,656 per loan.

The Director, Home Mortgage Insurance Division, stated that the Housing staff had determined in about August 1996 that the escrow commitment procedure was in conflict with the law. He stated that they had made the determination without obtaining a legal opinion from the Office of General Counsel. The Director stated that the conflict with the law was inadvertent. He said Housing staff plan to request a change in the law to permit the escrow commitment procedure but do not plan to suspend the procedure until a change can be considered by Congress. The Senior Program Analyst in the Office of the Deputy Assistant Secretary for Operations stated that an amendment had been drafted and possibly would be included in the HUD fiscal year 1998 Authorization Bill.

From 1991 through July 1996, HUD endorsed about 6,770 investor and non-profit loans. Based on our audit sample, most of these loans probably were closed using the escrow commitment procedure. Because it exceeds the Department's current authority, the procedure should be discontinued immediately and until authorized by law.

Response to draft final report

By memorandum of January 14, 1997, the Deputy Assistant Secretary for Single Family Housing stated that her staff was pursuing this issue with the Office of General Counsel and would provide comments on the finding after the issue had been fully explored (see Appendix E-see footnote 1).

Recommendation

We recommend:

- 2A. HUD immediately notify lenders that use of the escrow commitment procedure is suspended until further notice.

Follow-Up On Prior Audits

This was the initial audit of the Section 203(k) Mortgage Program.

In 1990 the Office of Inspector General conducted an audit of National Mortgage Corporation of Indiana. As a result of that audit, the Office of Inspector General issued Audit Related Memorandum No. 90-TS-121-0804, dated August 16, 1990. The subject of the memorandum was Section 203(K) Rehabilitation Home Mortgage Insurance Program Weaknesses. It included 6 findings and 10 recommendations, which were resolved.

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Schedule of Lenders and Loans Reviewed

We reviewed the following lenders and loans:

<u>Lender</u>	<u>Borrowers</u>	<u>Loans Reviewed</u>	
		<u>Location</u>	<u>Number</u>
Bankers Surety Association	1 Investor	California	8
Directors Mortgage Loan Corporation	11 Investors	Georgia	27
FT Mortgage Companies d/b/a Carl I. Brown Company	1 Non-profit	California	21
FT Mortgage Companies	1 Investor	Massachusetts	8
Tidewater First Financial Group Inc.	1 Investor	N. Carolina	6
Unity Mortgage Corporation	1 Investor	Georgia	5
Waters Mortgage Corporation	1 Non-profit	Florida	107
Waters Mortgage Corporation	1 Non-profit	Florida	66
Waters Mortgage Corporation	1 Non-profit	Georgia	21
Waters Mortgage Corporation	1 Non-profit	Illinois	13
Waters Mortgage Corporation	1 Non-profit	Texas	<u>37</u>
Total loans reviewed			<u>319</u>

We have also reviewed and included the results of monitoring reviews of the HUD Office of Lender Activities for the following lenders and loans:

<u>Lender</u>	<u>Borrowers</u>	<u>Loans Reviewed</u>	
		<u>Location</u>	<u>Number</u>
Bankers Surety Association	2 Investors	California	11
Community Financial Services	1 Non-profit	Michigan	6
Community Financial Services	1 Non-profit	Ohio	3
Directors Mortgage Loan Corporation	4 Investors	Virginia	28
DMR Financial Services Inc.	1 Non-profit	Ohio	2
FT Mortgage Companies d/b/a Carl I. Brown Company	46 Investors	Illinois	73
Total Lender Activities Reviews			<u>123</u>

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Summary of 203(k) Program Procedures

Following is a summary of how the 203(k) Program works.

The program can be used to rehabilitate dwellings in one of three ways: (1) purchase a dwelling and the land on which the dwelling is located, (2) purchase a dwelling on another site and move it onto a foundation on the mortgaged property, and (3) refinance existing indebtedness. Eligible properties include one to four family dwellings that have been completed for at least one year and homes that have been demolished or need to be razed if the existing foundation system is not effected and will be used. A one family dwelling can be converted to a two to four family dwelling or a multi-unit dwelling can be decreased to a one to four family unit; and a property that is used for residential and commercial purposes may be eligible under certain circumstances.

The potential borrower locates an eligible property. The borrower submits an application to a lender and enters into a sales contract that is contingent upon 203(k) loan approval and the borrower's acceptance of any additional required improvements as determined by HUD or the lender.

Either the borrower or a consultant prepares a work write-up and cost estimate. The rehabilitation must include at least \$5,000 of eligible improvements on the existing structure on the property. Any repair is acceptable in the first \$5,000 requirement that may affect the health and safety of the occupants. Minor or cosmetic repairs by themselves cannot be included in the first \$5,000, but may be added after the \$5,000 threshold is reached. Following the lender's acceptance of the work write-up and cost estimate, the lender requests assignment of a HUD case number. A plan reviewer meets with the borrower and contractor at the property to ensure that the work write-up and cost estimate are acceptable and all program requirements are met. A written appraisal is prepared of the expected property market value after rehabilitation work is completed. In some cases, an as-is appraisal is also required.

The lender reviews the application and the appraisal to determine the maximum insurable mortgage amount for the property. The mortgage amount is limited to the loan-to-value ratio and maximum dollar amount that apply to similar properties under Section 203(b). The value of the maximum mortgage calculation is based on the lesser of (1) as-is value of property plus rehabilitation costs or (2) 110 percent of the expected property market value after rehabilitation work is completed. The as-is value of the property is usually based on the borrower's purchase price, or for refinance cases, an as-is appraisal. The rehabilitation cost can include up to six mortgage payments to assist the borrower when the property is not occupied during rehabilitation. The maximum mortgage amount for owner occupants and non-profit borrowers is based on 97/95 percent of the maximum mortgage calculation. The maximum mortgage amount is based on 85 percent of the maximum mortgage calculation if the property is purchased for investment purposes. The lender completes a review of the borrower's credit and ability to repay the loan.

The 203(k) loan is then closed and the lender submits copies of the mortgage documents to HUD for review. If documents are found acceptable, HUD issues a Mortgage Insurance Certificate to the lender.

The borrower then has up to 6 months to complete the rehabilitation work. As the rehabilitation work progresses, funds are released from the rehabilitation escrow account after the work is inspected by a HUD approved inspector. Any unused funds in the rehabilitation escrow account are applied to the mortgage. If the escrow commitment procedure is used, the lender continues to administer the escrow account (see Appendix C).

Escrow Commitment Procedure

The purpose of the 203(k) Program's escrow commitment procedure is to encourage program participation by investor and non-profit borrowers. The procedure allows the investor or non-profit borrower to sell the property, after the rehabilitation work is completed, to a buyer who assumes the 203(k) loan without the cost of a new loan. The procedure makes it easier for the borrower to sell the property and thus, increases the borrower's chance of making a profit.

Under the escrow commitment procedure, an investor borrower who purchases an investment property but intends to sell the rehabilitated property to a mortgagor acceptable to HUD, can qualify for a mortgage based on the market value of the property after rehabilitation. The difference between the downpayment requirements for an owner-occupant and an investor is retained in an escrow account.

If the property is sold prior to the 18th amortization payment of the mortgage, the escrow amount is paid to the borrower. If the property is not sold by the 18th payment, the escrow amount must be applied to reduce the mortgage amount to an amount available for an investment property.

A first time homebuyer can assume the mortgage for no downpayment. An owner-occupant who is not a first time homebuyer must provide a downpayment. Another investor can assume the loan by making a 15 percent downpayment. If the resale price is less than the appraised value of the property, the mortgage amount must be reduced so that the purchaser maintains a minimum downpayment based on the acquisition price. If the resale price is greater than the appraised value, the purchaser must make a larger downpayment.

Following is an example of the escrow commitment procedure. Assume an investor borrower can purchase a property for \$50,000 and the cost of rehabilitation will be \$20,000. The borrower will have to make a 15 percent downpayment (\$10,500) on the acquisition cost of \$70,000 (\$50,000 + \$20,000). If the after-rehab appraisal shows the market value of the property will be \$100,000 after the completion of the rehabilitation, then the mortgage for an owner-occupant who will assume the loan will be \$95,500 (an owner-occupant will make a 95/97 percent downpayment or \$4,500). The borrower will apply \$10,500 to the escrow account and the loan proceeds will provide \$25,500 (\$95,500-\$70,000). When the loan is assumed by a qualified borrower, the total amount of \$36,000 in the escrow commitment account will be released to the investor borrower. A first time homebuyer could assume the mortgage for no downpayment.

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