audit report
OFFICE OF INSPECTOR GENERAL

Issue Date
September 4, 1997
Audit Case Number
97-SF-123-0002

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

FROM: Glenn S. Warner, District Inspector General for Audit, 9AGA

SUBJECT: Sales of HUD-Owned Properties
Single Family Real Estate Owned Branch
Arizona State Office

We have completed an audit of HUD's Real Estate Owned (REO) Branch at the Phoenix, Arizona office. Our audit focused on sales of HUD-owned properties where the sales price of, and related FHA-insurance on, the properties appeared excessive. This report contains one finding and recommends actions necessary to protect the homebuyers HUD serves while protecting the Department's FHA insurance fund.

Within 60 days please furnish 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 not necessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

If you have any questions, please call me or David McCargar, Assistant District Inspector General for Audit at (415) 436-8101.

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Executive Summary

We completed a limited audit of HUD's REO Branch at the Phoenix, Arizona office. The audit objective was to determine whether current REO sales practices result in the sale of properties at amounts significantly greater than their fair market values and, if so, the consequences of such practices to HUD and the homebuyers.

HUD's Current Policy Increases The Insurance Risk And Victimizes Homebuyers

HUD's policy covering REO sales, which allows insured mortgages to be based on the sales price, even if greater than the property's appraised value, has resulted in higher insured mortgages than HUD allows under other single family sales where HUD is not the seller. In our opinion, this policy increases HUD's insurance risk and, more importantly, results in the victimization of low and moderate income first-time homebuyers who pay excessive prices for the properties.

When HUD is not the seller, the basis for FHA-insured loan amounts is limited to the lower of the property's sales price or appraised value. This serves to limit the insurance risk and provide protection to unsophisticated homebuyers. This limitation does not apply to REO sales where HUD has knowingly insured mortgages far in excess of the properties' appraised values. We attribute this difference in policy to HUD's desire to maximize returns to the insurance fund on the sale of foreclosed properties and an apparent "buyer beware" attitude. However, in our opinion, this policy does not properly consider the higher insurance risk or the ethical implications of knowingly allowing others to take advantage of uninformed first time low and moderate income homebuyers.

The consequences of HUD's policy were readily apparent during our review of 29 REO properties which were sold for more than 110 percent of their appraised value. Borrowers we interviewed did not fully understand that they had paid from $9,200 to $28,800 more than the fair market value of the properties. Twenty eight of these sales were to low and moderate income or first time homebuyers and 24 percent of the mortgages are already in default or foreclosure. Borrowers stated that they had relied on their realtors, HUD, and the perception (fostered by HUD) that buying a HUD home is a good bargain.

As long as HUD continues its national policy of insuring HUD-owned property sales without regard to loan-to-value ratios (i.e., appraised values), unsophisticated homebuyers will continue to be exploited. Further, HUD's short term gains from the sale of properties at inflated prices may be offset by the subsequent insurance losses resulting from the over-insured loans. In our opinion, HUD should equitably balance its fiduciary responsibility to maintain the FHA insurance fund with its fiduciary responsibility to its single family housing program homebuyers and families.

Auditee Comments

We provided a copy of the draft finding to you for comment on June 23, 1997 and requested your comments by July 25, 1997. We also offered to meet with you to discuss the findings so we could consider your comments before issuing our report. You did not provide any comments or request a meeting.

Recommendations

We recommend that HUD adopt amended policies which limit the amount of FHA-insurance available on REO sales to a realistic percentage of HUD's appraised value of the property, as is currently done when HUD is not the seller.

Table of Contents

Management Memorandum i

Executive Summary iii

Introduction 1

Finding

1 Overinsurance of Mortgages on REO Property Sales Contributes to Victimization of Homebuyers and Increases HUD's Insurance Risk 3

Appendices

A Schedule of Mortgage and Mortgagor Characteristics 11

B Distribution 13

Abbreviations

AZ	Arizona
CFR	Code of Federal Regulations
FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
REO	Real Estate Owned

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Introduction

BACKGROUND

The National Housing Act, as amended, confers on the Secretary the authority to manage, rehabilitate, rent and dispose of any property acquired in settlement of a claim under HUD's mortgage insurance programs. The primary responsibility for day-to-day property disposition activities is delegated to the Real Estate Owned (REO) Branch at the local HUD Office. The objective of HUD's property disposition program is to reduce the inventory of acquired properties in a manner that maximizes the return to the insurance funds while balancing the need to preserve and maintain residential areas and communities.

Prior to September 1990 HUD used its Area Management Brokers (now known as Real Estate Asset Managers) to estimate the market values of its acquired properties. Subsequent to October 1, 1990 values of acquired properties and related sales listing prices have been established through appraisals conducted by independent real estate appraisers using nationally recognized industry standards. Accordingly, list prices should reflect the true value of the properties.

Under HUD's normal sales procedures, acquired properties are listed for sale at the appraised value. HUD accepts the highest net bid price for the properties, if the bid meets the minimum bid requirements established by the local office for the property. The maximum FHA insurance amounts for REO properties sold by HUD are established by the bid price, even when the bid amount exceeds the HUD-appraised value. This is in contrast to the regular FHA single family insurance program where the maximum insurable mortgage limits are based on the **lower** of appraised value or purchase price. In the case of REO properties, if purchase prices are higher than actual values of the properties, then the insured mortgages are also much more than the properties' market values.

OBJECTIVES, SCOPE AND METHODOLOGY OF THE AUDIT

The objectives of the review were to determine whether:

- REO sales reflected the actual values of the properties;
- Purchasers were aware that prices they paid for properties were significantly more than HUD's determined fair market values, and if so, why they were willing to pay significantly more than the properties' true value.
- HUD was put at risk on insured sales where the sale prices and related FHA insurance amounts were significantly higher than the actual value of the properties, and if so, what actions could be taken to reduce risk.

The audit generally covered the period October 1, 1994 through July 1996. Where appropriate, we extended the review to cover other periods. The audit was conducted in accordance with generally accepted government auditing standards.

Audit procedures and methodologies for the audit included, but were not limited to:

- Obtaining a listing of all Phoenix Office REO sales for the period October 1994 through July 1996 to create a data base and identify those properties which sold for more than 110 percent of list price. We identified over 900 properties which were sold for more than 110 percent of list price during our audit period. From these we judgementally selected 29 cases for detailed review.

- Obtaining an independent licensed appraiser to review the accuracy and quality of HUD's appraisal reports for 26 of the 29 properties selected for review;

- Interviewing purchasers and lenders' staff which were involved with the 29 properties selected;

- Reviewing REO Branch files on the 29 properties and interviews with REO Branch staff;

- Reviewing lender files and supporting documentation relating to the 29 properties; and

- Reviewing public records.

We attempted to obtain nationwide statistics from HUD Headquarters relating to property disposition sales and subsequent defaults in order to analyze default trends on properties which were sold and reinsured for significantly more than HUD determined values. Although we made numerous phone calls to responsible HUD Officials and requested the information in writing from HUD's Deputy Assistant Secretary for Single Family Housing, we were not provided the information requested. We consider this a serious data limitation which affected our ability to properly review this area.

Overinsurance of Mortgages on REO Property Sales Contributes to Victimization of Homebuyers and Increases HUD's Insurance Risk

HUD's policy on REO sales, which allows insured mortgages to be based on the sales price, even if greater than the property's appraised value, has resulted in higher insured mortgages than HUD allows under other single family sales where HUD is not the seller. In our opinion, this policy increases HUD's insurance risk and, more importantly, results in the victimization of low and moderate income first-time homebuyers who pay excessive prices for the properties.

When HUD is not the seller, the basis for FHA-insured loan amounts is limited to the lower of sales price or appraised value. This serves to limit the insurance risk and provide protection to unsophisticated homebuyers. This limitation does not apply to REO sales where HUD has knowingly insured mortgages far in excess of the properties' appraised values. We attribute this to HUD's desire to maximize returns to the insurance fund on the sale of foreclosed properties and an apparent "buyer beware" attitude. However, in our opinion, this policy does not properly consider the higher insurance risk or the ethical implications of knowingly allowing others to take advantage of uninformed first time low and moderate income homebuyers.

The consequences of HUD's policy were readily apparent during our review of 29 REO properties which were sold for more than 110 percent of their appraised value. Borrowers we interviewed did not fully understand that they had paid from $9,200 to $28,800 more than the fair market value of the properties. Twenty eight of these sales were to low and moderate income or first time homebuyers and 24 percent of the mortgages are already in default or foreclosure. Borrowers stated that they had relied on their realtors, HUD, and the perception (fostered by HUD) that buying a HUD home is a good bargain.

A. Insured Mortgages for REO Sales are Based on the Sales Price without Regard to Appraised Values While Insured Mortgages for Non-REO Sales are Limited by Appraised Values

Under current HUD policy, appraisals are obtained on all REO properties to determine their market value. The appraisals are conducted by independent real estate appraisers using nationally recognized industry standards. List prices are then established based on these appraisals [24 CFR 291.100(b)]. Accordingly, list prices should reflect the true value of the properties. However, HUD does not use the appraised value/list price in determining or limiting the maximum insurable mortgage on the property if FHA insurance is obtained. Instead, in accordance with 24 CFR 291.115(b)(2) ... "the mortgage amount is based on the **bid price** plus any allowable prepaids (e.g., taxes) and financing or closing costs, up to local maximum mortgage amounts." Thus, if sales prices are higher than actual values of the properties, the insured mortgages are also higher. This could result in high risk loans since it would be difficult for mortgagors to dispose of the properties because of the inflated mortgages.

Unlike REO sales, strict rules limit the amount of FHA mortgage insurance for single family properties where HUD is not the seller. Under regulations in 24 CFR 203.18, the maximum loan-to-value limitation is 97% of the ***appraised*** value for loans up to $50,000 and for loans over $50,000 this limitation is generally 97% of the first $25,000 of the appraised value plus 95% of the appraised value in excess of $25,000. These limitations may not be exceeded regardless of the sales price (eg., if the buyer paid more than the appraised value.) Only the 203(k) program allows the maximum insured value to be based on a value greater than the appraised value. Even this exception limits the maximum insurance amount to the lesser of as-is value plus cost of rehabilitation or 110% of the after-improved value (Mortgagee Letter 97-05).

B. Over-insured Loans on REO Sales were Previously brought to HUD's Attention

We alerted your office of possible problems related to sales of HUD-owned single family properties in an Audit Related Memorandum dated May 9, 1996 to the Deputy Assistant Secretary for Single Family Housing.[1] The memorandum reported on our review of allegations that the sale prices of REO properties in Phoenix, Arizona and the related FHA-insured mortgages often far exceeded the real value of the properties and that purchasers of these properties were being taken advantage of by both realtors and HUD. We recommended a review of the existing policy for determining the maximum mortgage for REO sales to determine whether the policy may result in excessive risk or payment of excessive prices by homebuyers.

In her response, The Deputy Assistant Secretary stated that she felt secure with the current policy and did not believe that a change in policy was appropriate since HUD's risk on overinsured loans resulting from current policy was insignificant. The July 16, 1996 reply stated that this decision was primarily based on a Single Family Housing (Housing) study of claims paid on REO sales for the period October 1, 1991 through September 30, 1992. The reply did not address the ethical problem we raised of HUD's knowingly participating in the sale of properties to unknowledgeable homebuyers for much more than their true value.

C. We Performed Additional Audit Work On Overinsured Loans

Because the Deputy Assistant Secretary's July 16, 1996 response did not adequately address the issues we raised, we performed additional audit work. We found that during the period October

[1] Audit-Related Memorandum No. 96-SF-123-0805

1994 through July 1996, at least 60 realtors sold over 900 HUD-owned homes in the Phoenix office's jurisdiction at 110 percent or more above indicated property values (i.e., list price). The buyers paid $10.4 million more than the appraised property values with an average overpayment of $11,000 or 118 percent of list values. These figures indicate that significant problems and issues existed with the sale of REO properties: Either the list prices (and appraisals) of properties are not realistic or buyers are paying too much (significantly more than the value of the properties.)

To address our concerns, we selected for detailed analysis, 29 FHA-insured REO sales which occurred during the period October 1994 through June 1996 where the sales price and insured loan amount exceeded 110 percent of the property's list price/appraised value (The ratios in the sample ranged from 111% to 173% in excess of the properties appraised values). Our analysis included a re-examination of the properties' appraised values; interviews with the homebuyers (where possible); and an analysis of the lenders' loan origination files. The results of our review are detailed below:

1. HUD's List Prices/Appraised Values Were Accurate

We confirmed that buyers were paying excessive prices (more than market value) for properties by hiring an independent appraiser to determine the reasonableness of HUD's list prices for 26 of the 29 properties in our sample. For 22 of the 26 appraisals reviewed, the independent appraiser concluded that the comparables used were appropriate and the property value determinations of the original appraisals were reasonable. In the four cases where the review appraiser questioned the original appraised values, the differences except for in one instance, were minimal. Even in this one instance the sales price was 132% greater than the review appraiser's estimated value of the property.

Based upon the results of our analysis of the values of REO properties, it is apparent that the significant differences between sales and list prices were not a result of inaccurate appraisals. Rather, the sales prices were excessive in relation to the value of the properties.

2. Homebuyers Did Not Understand that HUD's List Price Represented the Value of the Home They Purchased

We interviewed purchasers of the properties included in our sample to obtain their thoughts and understanding of the purchase process, including HUD's listing prices and how they related to the properties' actual values. Many of the borrowers we interviewed stated that they did not realize that they had paid far more (from $9,200 to $28,800) than the fair market value of the properties. The purchasers stated that during the purchase process they had relied on their realtors, HUD, and their belief that buying a HUD home is a good bargain. In our opinion, the purchasers were let down by all parties. As a result, they paid far more than actual value for the properties.

Almost all of the owner-occupant buyers in our sample were first time homebuyers. These first time homebuyers appeared to have been overwhelmed by the purchase process and the many documents they had to sign. They were also unfamiliar with the home buying process. Accordingly, the purchasers relied on the realtors to set their bid price and handle all aspects of the purchase process. ***In at least two instances the purchasers did not even know the amount of their bid until after they had been notified that their offer was accepted.*** In these instances, the realtor had determined the bid amounts without consulting the purchasers.

The purchasers were also unaware of the negotiable portion of the bid price, including the realtors' fee. (The maximum realtor's fee for a REO sale is 6 percent, but is negotiable. The typical realtor's fee in the Phoenix market when the realtor is not the listing broker, is 3 to 3.5 percent).

We believe that some realtors were encouraging buyers to bid extremely high without regard to the property's value since HUD would provide an FHA-insured loan on whatever price was bid. Such actions could cause other realtors to become discouraged when bidding market value if they and their clients continued to be out-bid by wide margins. As a result, many realtors may have reacted by also having their clients bid far above market value in order to remain competitive and win bids for sales of HUD owned properties.

3. The Majority of Purchasers were Low and Moderate Income Families

Sixty percent of the purchasers in our sample were low and moderate income families. Although the purchasers qualified for the FHA-insured loans they obtained, their resources were stretched to the limit. The significantly higher mortgage payments resulting from their purchase of the properties at greater than market value and the use of Adjustable Rate Mortgages, exacerbated this problem. The purchasers are locked into higher payments that increase annually and cannot sell their properties without incurring a loss because the mortgage balances are significantly higher than the properties' values.

This problem was illustrated by a family we met during our audit. The family was distraught about what to do regarding a HUD home they bought a year ago. They stated they need to sell the home and live within their means, but are having difficulty because their mortgage is so much greater than the property's value. We found that they had paid $107,501 for a HUD-owned home with an appraised value of $95,000 ($12,501 over value). The loan was overinsured with a loan-to-value ratio of 112 percent. Their dilemma is further complicated since their initial 4.5 percent adjustable rate mortgage is about to adjust to 6.5 percent and increase their mortgage payment from $696 to approximately $827 per month. It is just such situations which demonstrate the increased foreclosure risk resulting from insuring loans at significantly more than a property's value.

4. Consequences of HUD's Current Policy

As discussed above, the practice of selling REO properties and allowing FHA-insurance to be obtained at amounts significantly more than their value has serious consequences, including the exploitation of the first time low and moderate income homebuyers involved and the increased insurance risk. In our opinion, it is inappropriate for HUD to knowingly allow such buyers to be exploited by permitting them to pay unreasonable prices for REO properties.

a. Policy Results in the Exploitation of those HUD is Tasked to Serve

According to HUD's Program and Management Priorities for the Office of Housing/FHA, HUD's mission is to expand housing opportunities, including home ownership. HUD is tasked with helping low and moderate income households and families buy decent, safe, affordable housing. HUD's Program and Management Plan states that the Office of Housing must balance its mission of expanding housing opportunities with its fiduciary responsibility to maintain the financial health and soundness of the FHA Insurance Fund. However, this fiduciary responsibility does not include maintaining the fund at the expense of the very households the FHA Program was designed to help through provision of affordable housing opportunities. HUD's sale of REO properties and provision of FHA-insured loans at more than the homes' fair market value serves to exploit the first time homebuyers, low and moderate income families and minorities who typically purchase REO properties. ***We believe such a policy is unconscionable for a Federal program intended to help such purchasers.***

Additionally, such a policy could result in serious adverse publicity to HUD if and when the media ever picked up on this situation. Over and above the embarrassment such adverse publicity could cause the Department, it could also seriously undermine HUD's advertising efforts wherein REO properties are promoted both locally and nationally as a good buy. If those interested in purchasing REO properties lose this perception and begin to believe that REO properties are in fact not a bargain, HUD's success in selling these properties could evaporate.

b. Increased Insurance Risk

As previously discussed, and set out in Appendix A, seven of the twenty nine loans (24%) included in our sample are currently in default or foreclosure. This is a significantly greater percentage than the default rate for FHA-insured loans where insurance amounts (and effectively sales prices) were based upon the market value of the properties. As previously mentioned, the Deputy Assistant Secretary for Single Family Housing, in a July 16, 1996 memorandum to our office, stated that based on a study (mini review) of 1992 data, increased insurance risk on over-insured loans was insignificant. In our opinion, this review was out of date and too limited to be used as a basis for determining risk on over-insured loans. We believed more recent and comprehensive data would be more meaningful and accordingly asked the Director of the Single Family Property Division to provide us with more recent REO sales and default data. The Director **declined** our request and stated that "Program decisions have already been made.." regarding REO overbids (and the resulting overinsured loans) based on the 1992 data. We subsequently sent a memorandum dated November 27, 1996 to the Deputy Assistant Secretary for Single Family Housing seeking cooperation and asking her to direct her staff to provide data for fiscal years 1995 and 1996 and any additional information needed. We received no response to our request for assistance. Accordingly, we could not determine the magnitude of the effect of over-insured loans on a nationwide basis. However, common sense, just as the results of our review, indicate a significant insurance risk on such loans. Because the loans are significantly more than the value of the properties, owners would not be able to sell the properties if changing circumstances require them to do so. Thus, the properties would likely go into foreclosure, and HUD's resultant resale would most likely be at an amount significantly less than the claim paid on the overinsured value.

D. The Deputy Assistant Secretary for Single Family Housing's Proposal for Addressing the Problem of Excess Sales Prices May not Work

Housing's July 16, 1996 response to our audit-related memorandum stated that... "In an effort to ensure that purchasers are aware of the property values established by HUD, an addendum was developed for offices to use and requires its submission along with the sales contract." We obtained copies of the addendum and found that it is just one of many documents the homebuyers sign. One example of the Addendum reads similarly as follows:

> I (we) understand that HUD's Estimate of Value for the property located at: __________, Phoenix, AZ is $66,000. The offer being submitted in the amount of $79,250 (item 3 of Sales Contract) is done with full knowledge of HUD's Estimate of Value for this property.

For the example cited, the co-borrower/parent who signed the addendum to the sales contract was not a first time homebuyer, unlike the majority of the purchasers we interviewed. Nonetheless, when we interviewed him and asked if he had known he was paying $13,250 more than the home's appraised value, he stated that, even with this disclosure he did not know that the list price represented HUD's estimated value of property and had he fully understood so, "***... I wouldn't have bid that much***." This, in our opinion, demonstrates that simply attaching an addendum to a sales contract with a buyer beware clause is not the solution to this problem. This is especially true of uninformed first time homebuyers who are overwhelmed by the purchase process and don't read or understand the numerous documents that they are asked to sign.

Housing's July, 16, 1996 response and related correspondence also suggests that temporary or permanent denial of participation from the REO program could be taken against realtors who continue to submit inflated bids on behalf of their clients. However, HUD has no jurisdiction over realtors and their fiduciary responsibilities to their real estate clients and we question whether any such action would be upheld upon appeals given HUD's role in knowingly accepting the inflated bids and the subsequent over-insured loans. In our opinion, HUD is equally as culpable as the realtors in such situations.

* * * * *

As long as HUD continues its national policy of insuring HUD-owned property sales without regard to loan-to-value ratios (i.e., appraised values), unsophisticated homebuyers will continue to be exploited. Further, HUD's short term gains from the sale of properties at inflated prices may be offset by subsequent insurance losses resulting from the over-insured loans. In our opinion, HUD should equitably balance its fiduciary responsibility to maintain the FHA-insurance fund with its fiduciary responsibility to its single family housing program homebuyers and families. Accordingly, in our opinion, HUD should adopt amended policies which limit the amount of FHA-insurance available on REO sales to a realistic percentage of HUD's appraised value of the property, as is currently done when HUD is not the seller.

Auditee Comments

We provided a copy of the draft finding to you for comment on June 23, 1997 and requested your comments by July 25, 1997. We also offered to meet with you to discuss the findings so we could consider your comments before issuing our report. You did not provide any comments or request a meeting.

Recommendations

We recommend an immediate change to HUD's national policy for REO sales, other than its 203(k) program, to:

1A. Revise the current policy to apply the current loan-to-value limitations in Part 203.18(a) of 24 CFR and 203(b)(2) of the National Housing Act to sales of HUD owned properties as HUD already does when HUD is not the seller.

1B. Modify Part 291.115(b)(2) of 24 CFR to reflect the needed changes described in Recommendation 1A of this report.

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Schedule of Sample Mortgage and Mortgagor Characteristics

* - As of April 4, 1997 seven of the twenty-nine mortgages we reviewed were either in default or foreclosure, including paid claims.

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Distribution

Secretary's Representative, 9AS(2)
Director, Single Family Division, Phoenix Office, 9EH(2)
Chief, Single Family Real Estate Owned Branch, Phoenix Office, 9EHSR
State Coordinator, Phoenix Office, 9ES(2)
Director, Field Accounting Division, 9AFF
Director, Administrative Service Center 3, Denver, 9AAR
Assistant to the Deputy Secretary for Field Management, SDF (Room 7106)
Office of the Comptroller (Attn: K.J. Brockington), Texas State Office, 6AF
Deputy Assistant Secretary for Single Family Housing, HS
Audit Liaison Officer, HF (Room 5132)(4)
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Director, Office of Policy Support, WS (Room 10130)
Director, Housing and Community Development Issue Area,
U.S. GAO, 441 G Street,NW, Washington, DC 20420, Attn: Judy England-Joseph
Department of Veteran Affairs, OIG (52A), 810 Vermont Ave., NW, Washington, D.C. 20420
Mr. Pete Sessions, Government Reform and Oversight Committee, Congress of the United States, House of Representatives, Washington, D.C. 20515-4305
The Honorable Fred Thompson, Chairman, Committee on Governmental Affairs, United States Senate, Washington, D.C. 20510-6250
The Honorable John Glenn, Ranking Member, Committee on Governmental Affairs, United States Senate, Washington, D.C. 20510-6250
Ms. Cindy Sprunger, Subcommittee on General Oversight and Investigations, Room 212, O'Neill House Office Building, Washington, D.C. 20515

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