audit report
OFFICE OF INSPECTOR GENERAL

Issue Date September 17, 1999	
Audit Case Number 99-AT-123-0001	

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

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

SUBJECT: Single-Family Property Disposition Program

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

Please furnish this office a reply within 60 days on each recommendation describing: (1) the corrective action taken; (2) the proposed corrective action and a planned implementation date; or (3) why action is not considered necessary. Also, please furnish us copies of any correspondence or directives issued as a result of the audit. Note that Handbook 2000.06 REV-3 requires management decisions to be reached on all recommendations within 6 months of report issuance. It also provides guidance regarding interim actions and the format and content of your reply.

We appreciate the cooperation of your staff during the audit. If you or your staff have any questions, please contact me at 404-331-3369 or Jerry Kirkland, Assistant District Inspector General for Audit, at 423-545-4368.

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Executive Summary

Over the years, the Department of Housing and Urban Development (HUD) has struggled to refine the way it does business. Under Secretary Andrew Cuomo, HUD is focused on a "HUD 2020 Reorganization Plan," designed to ready the Department for the 21st century. In March 1997, FHA proposed its Field Consolidation Plan for Single Family Housing. The plan was to consolidate field functions into homeownership centers for processing and underwriting, asset management, marketing and outreach, and quality assurance. Homeownership Centers were to be fully operational by October 1998, including outsourcing property disposition activities and selling nearly all assigned notes. With this plan in hand, management began reorganizing staff.

In March 1998, the General Accounting Office (GAO) reported on FHA's Property Disposition Program. GAO concluded that FHA did not have adequate controls in place to oversee its Real Estate Asset Management (REAM) contractors and that property conditions were deteriorating.

By late summer of 1998, it was clear the Secretary was not on target with his 2020 implementation goals. We became concerned that staff buyouts, early retirements, and staff reassignments had increased the risk of fraud and abuse in FHA's programs. We began an audit of the Property Disposition Program to determine FHA's ability - while in transition to outsourcing its management and marketing services - to monitor and oversee property disposition activities. This report presents the results of our assessment through March 1999.

Every year, in the normal course of business, FHA acquires properties in exchange for payment to mortgage lenders of their insurance claims. HUD's mission is to reduce this inventory in a manner that:

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

Our audit disclosed no improvement in program operations since GAO's report. Subsequent to field consolidation, inventory increased, sales to homeowners declined, age and condition of FHA properties deteriorated, revenue was lost, and holding costs increased. FHA continued to have poor control over its REAM contractors. Because of staff shortages caused by the reorganization, FHA management issued emergency contracts, and placed temporary, inexperienced, and/or untrained HUD staff in property disposition jobs. The effort did not overcome the problems. FHA received numerous reports of non-performance by REAMs, but took little enforcement action because it had no system to record, track, or quickly respond to these reports.

FHA was unable to maximize return to the insurance fund. Performance is based, in part, on FHA's ability to sell properties within 5 months of acquisition. FHA also attempts to maximize its return and retain integrity of property values in surrounding neighborhoods by selling its properties at no less than 98 percent of appraised value. These goals are well within industry standards. However, we determined that FHA was unable to meet these goals. FHA's average holding time for properties sold in Fiscal Years (FY) 1997 and 1998 was 182 days per property or 32 days longer than its goal. In FY 1996, sales averaged 98.5 percent of appraised values, but by the end of FY 1998, FHA's average ratio of sales price to appraisal had dropped to 94.9 percent. In total, the combination of excess holding cost and lost revenue totaled over $269 million for FY 1997 and 1998.

In March 1999, FHA awarded 16 Management and Marketing (M&M) contracts totaling $927 million over 5 years to manage and market its properties nationwide. FHA designed an extensive monitoring guide to monitor contractors, including a comprehensive risk assessment to be completed monthly on each contract. FHA also awarded property inspection and file review contracts to help staff monitor the 16 M&M contracts. FHA has revamped its property disposition operation to the point that it cannot now easily reverse course; it is imperative that outsourcing succeed.

Based on our assessment of FHA's approach and its struggle over the last 2 years, we have serious concerns that FHA management has underestimated the efforts needed for program success. We believe that: (1) the future FHA staffing planned to oversee M&M contracts has not been adequately projected to protect the government's interests, (2) FHA lacks adequate enforcement strategies and recovery plans when contractors fail to perform, and (3) FHA's program mission and performance goals will suffer as a consequence. Our recommendations address these concerns.

We will monitor the implementation of the M&M contracts and continue to apprise the Commissioner and Congress of any concerns.

FHA's response to the draft report

On July 7, 1999, we held an exit conference with FHA officials to discuss a preliminary draft of our report. Based on this discussion, we agreed to review additional information FHA provided. We revised the report and issued our official draft on July 23, 1999. FHA provided written comments to our findings and recommendations on September 2, 1999. FHA generally disagreed with Findings 1 and 2 but agreed with our recommendations. It generally agreed with Finding 3 and its recommendations. We considered FHA's comments in preparing our final report. The comments are summarized within each finding and included in their entirety as Appendix D.

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Abbreviations

CFR	Code of Federal Regulations
FHA	Federal Housing Administration
FTE	Full Time Equivalent
FY	Fiscal Year
GAO	U.S. General Accounting Office
HOC	Homeownership Center
HUD	U.S. Department of Housing and Urban Development
M&M	Management and Marketing
MPS	Minimum Property Standards
NPR	National Performance Review
OIG	Office of Inspector General
REAM	Real Estate Asset Manager
REO	Real Estate Owned
SAMS	Single Family Acquired Asset Management System

Introduction

Background

FHA's Single Family Mortgage Insurance Program helps low and moderate income families become homeowners by reducing downpayments and limiting lender fees. FHA currently insures about 7 million loans valued at over $400 billion. Every year, thousands of borrowers default on their FHA-insured loans. When they default, FHA encourages lenders to work with them to bring their payments current. If they cannot do this, their homes may be sold to third parties, voluntarily conveyed to the lenders, or surrendered to lenders through foreclosure. Once lenders obtain the properties, they generally convey title to the Secretary of HUD in exchange for payment of their insurance claim. During FY 1998 FHA paid over 76,000 claims totaling about $5.8 billion. It also takes possession of abandoned properties secured by FHA-held mortgages, referred to as "custodial" properties, pending acquisition of title.

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

FHA disposes of properties through its Property Disposition Program. Its mission is to reduce the property inventory in a manner that expands home ownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the mortgage insurance fund. FHA's Office of Insured Single Family Housing, Asset Management Division, is responsible for administering the program.

FHA has the largest real estate portfolio and operation in the nation. It sold about 122,000 properties and generated revenues of about $7 billion for the mortgage insurance fund during the last 2 fiscal years. As of February 28, 1999, there were about 42,300 properties in FHA's inventory valued at about $3.5 billion. These properties are in inventory an average of about 6 months. In addition, FHA held about 1,200 custodial properties. These are properties secured by FHA-held mortgages but HUD does not have title to them. About 40 percent of the custodial properties have been in FHA's inventory for over 3 years; some for more than 10 years.

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

In March 1997, Andersen Consulting prepared an Industry Benchmarking and Best Practices report to allow HUD to draw conclusions regarding its program performance. The report focused on best practices used in private industry Real Estate Owned (REO) operations. Based on the report, FHA developed goals for various critical success factors. The goals included: (1) selling properties at 98 percent of appraised value; (2) attaining a 150 day average property holding period; and reducing the percentage of properties in inventory more than 12 months to 5 percent.

In February 1993, HUD initiated a reinvention effort to streamline HUD operations and reduce costs. FHA also began reducing program staff and consolidating its mortgage insurance processing, claims, and property disposition activities from 81 field offices into Homeownership Centers (HOC). In August 1994, the first of four centers opened in Denver, Colorado. At that time about 580 staff worked on the program.

In March 1997, FHA issued its 2020 Field Consolidation Plan for Single Family Housing. The plan included opening three additional HOCs, in Philadelphia, Pennsylvania; Atlanta, Georgia; and Santa Ana, California, and outsourcing property disposition activities and selling nearly all assigned notes.

FHA contracted out a variety of its program functions including property appraisals and about 220 contracts with REAM contractors to secure and maintain program properties nationwide. The contractors were required to inspect and secure properties, report their condition to FHA, notify interested parties of HUD's ownership, perform needed exterior and interior maintenance, and ensure that properties were free of debris and hazardous conditions. Because of staff reductions, some field offices were unable to adequately perform their program functions. In 1998, four contracts in Birmingham, Alabama; Jacksonville, Florida; Coral Gables, Florida; and Chicago, Illinois were awarded to provide management and marketing services.

As of March 1999, there were about 420 Full Time Equivalent (FTE) staff working on the program at FHA Headquarters, 4 HOCs, and field offices; a staff reduction of 28 percent since 1994.

Pilot Program

In 1996, in order to test the feasibility of contracting out program functions, FHA awarded three pilot M&M contracts to Golden Feather Realty Services, Inc. The contracts covered the New Orleans, Louisiana; Sacramento, California; and Baltimore, Maryland areas. The contractor provided extensive services previously performed by program employees. During the period October 1996 through February 1999, contract staff managed about 10,400 properties. They also sold about 8,500 of these properties.

	Beginning Inventory	Acquired	Sold	Ending Inventory
New Orleans	379	1,365	1,535	209
Sacramento	408	3,682	3,470	620
Baltimore	673	3,857	3,506	1,024
Total	1,460	8,904	8,511	1,853

A 1998 performance report by FHA concluded that the pilot program was successful.[1] It stated that the contractor attained sales goals, reduced the time properties remained in inventory, and increased the return to the insurance fund. No final assessment of the pilot program had been performed as of April 1999.

The total cost of the contracts was $36,637,378.

New Orleans	$ 5,952,214
Sacramento	12,525,068
Baltimore	18,160,096
Total	$36,637,378

In early 1997, at FHA's request, the OIG performed a limited review of the pilot contracts to identify areas vulnerable to waste, fraud, and abuse, and recommend ways to improve a planned nationwide management and marketing contract.[2] The report identified several weaknesses in the contracts including (1) failure to place restrictions on the use of identity-of-interest companies, (2) inclusion of vague and nonspecific contract terminology, (3) not requiring the contractor to maintain written policies and procedures, and (4) failure to require compliance with changes in FHA legislation, regulations, or FHA policies and procedures. The report also stated that the contracts did not define the difference between repair costs covered by contractor fees, and repair costs reimbursed the contractor by FHA. It also cited FHA for not aggressively pursuing titles for custodial properties in the REO inventory, and having unreliable data in the Single Family Acquired Asset Management System (SAMS), FHA's primary management information system. FHA generally agreed with the recommendations and took action to correct the deficiencies. These actions included adding various provisions and clarifying language in the M&M contracts and consolidating staff to pursue custodial property titles. A subsequent OIG audit of SAMS showed problems with system data.

[1] HUD internal report titled, Golden Feather Realty Services, Inc., Evaluation of the Second Year of Operation, October 1, 1997 to September 30, 1998, dated 3/23/99.

[2] Audit of the Single Family Real Estate Owned Pilot Contracts, HUD Office of Inspector General (98-AO-123-0001, January 1998).

Nationwide M&M Contracts

On March 29, 1999, FHA put the final phase of its reorganization plan into effect. It awarded 7 companies a total of 16 contracts to manage and market its properties nationwide. For about $927 million over 5 years, these companies will handle nearly every aspect of the program including property management, marketing, and sales. Other property inspection and file review contracts will be awarded to help staff monitor the M&M contractors. The estimated cost for the first year of these contracts is about $3.5 million.

The duties of HOC and field office program staff are expected to change dramatically. They will no longer manage and market properties. Their primary function will be to monitor contractor performance and enforce compliance. Once the contracts are operational, FHA estimates that 143 FTE (135 field, 8 headquarters) staff will be needed to oversee activities.

Prior Audit Findings

FHA has had a history of problems with REAM contractors. Reviews by the OIG and other audit organizations have frequently cited FHA for ineffective program management and reported contractor noncompliance and systemic abuse. For example, an OIG audit of the Massachusetts State Office in 1996 concluded that management had not established and implemented adequate controls to monitor and assess performance of REAM contracts.[3] The report cited missing and/or untimely REAM property inspection reports, little monitoring of contractor performance by FHA staff, and unacceptable property conditions. An OIG review in 1997 of FHA's Phoenix, Arizona office cited similar deficiencies.

In 1997, at Congress' request, GAO conducted a review of FHA's management of REAM contractors in Boston, Chicago, and Fort Worth. In March 1998, GAO reported that FHA did not have an adequate system in place to monitor oversight of REAM contracts. None of the FHA offices visited adequately performed all functions needed to ensure contract compliance. GAO's inspections of inventoried properties revealed serious problems such as vandalism, maintenance deficiencies, and safety hazards. The report also discussed FHA's plans to continue making changes to its property disposition process. GAO made several recommendations to strengthen FHA controls over REAM contractors.[4]

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[3] Controls Over Real Estate Asset Manager Contracts, Massachusetts State Office, HUD Office of Inspector General (96-BO-123-0001, June 1996).

[4] Improvements Needed in FHA's Oversight of Property Management Contractors (GAO/RCED-98-65, March 27, 1998).

A 1998 audit of FHA's financial statements performed by KPMG, LLP found similar control weaknesses.[5] The report stated that:

FHA has control weaknesses in its single family property acquisition, management and disposition functions which hindered FHA's objective to reduce inventory in a manner that maximizes the return to the mortgage insurance fund while preserving and protecting residential properties.

Deficiencies cited in the report included:

- Inadequate oversight of REAM services, including maintenance and repairs, real estate closing services, and other contract services.

- Deficient management, maintenance, and upkeep of program properties, including properties that were not secured and lacked signs identifying them as government properties available for sale, and properties where REAM employees appeared to be signing in for multiple visits.

- Delayed recognition and management of newly conveyed properties.

Audit Objectives

Our primary audit objective was to determine the effects of HUD's 2020 reorganization efforts on the mission of FHA's Property Disposition Program. This included assessing whether: (a) program operations were effective, efficient, and economical, and (b) management controls effectively identified and addressed operational deficiencies and contractor compliance.

Audit Scope and Methodology

The audit was conducted at FHA Headquarters in Washington, D.C. and at four HOCs located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California and various field offices. We also visited six contractor offices. (See Appendix A.) We reviewed activities and management controls over FHA's critical case processing steps 1 through 6. These steps included the processes to acquire and secure properties, record appraisals, determine the disposition method, and repair, maintain and market properties. We focused on controls over property management contractors because recent audits had identified significant control weaknesses involving FHA's monitoring of its contractors, contract compliance, and the condition of program properties. We also assessed management controls in the M&M contracts and the contracts management manual. Our audit was performed from August 1998 through April 1999 and primarily covered program activities from October 1996 through March 1999.

[5] Federal Housing Administration Audit of Fiscal Year 1998 Federal Basis Financial Statements (HUD Office of Inspector General Report (Performed by KPMG, LLP), 99-FO-131-0002, March 12, 1999).

To meet our objectives, we:

- Obtained information on current program operations, responsibilities, policies and procedures. Analyzed planned changes in regulations and discussed their implementation with Single Family Housing officials at FHA Headquarters, HOCs, and field offices.

- Interviewed contractors responsible for managing the FHA-owned and custodial properties.

- Assessed the extent and adequacy of FHA's monitoring of HOC and field office operations through interviews with responsible officials and reviews of monitoring reports.

- Reviewed operating budgets and staffing plans to identify significant changes that might affect program operations.

- Analyzed required monitoring logs and 181 monitoring reports to determine whether contractor visits were timely and required property inspections were performed.

- Compiled the results of 7,440 FHA property inspections.

- Reviewed 52 enforcement actions taken against non-compliant contractors.

- Reviewed 38 property case files judgmentally selected from contractor inventory lists to determine whether these contractors complied with contract requirements.

- Followed up on prior audit findings to determine whether recommendations had been implemented.

We also conducted 48 FHA-owned and 5 custodial property inspections. Of these 53 properties, 33 properties were the same as those in our case file review. Another 20 properties were judgmentally selected from the Atlanta, Chicago, Los Angeles, and Santa Ana field offices' inventory lists.

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

HUD's Reorganization Adversely Affected Its Program Mission

FHA did not effectively, efficiently, and economically manage its Property Disposition Program. HUD's reorganization efforts adversely affected staff resources and ability to adequately monitor the condition of program properties and enforce contractor compliance. Our review confirmed what FHA performance reports showed that property inventory increased, sales to homeowners declined, average losses from sales increased, and property conditions were deplorable. GAO and KPMG reported similar results. We found that performance worsened since their reviews were conducted. Consequently, FHA did not meet its basic program mission of reducing the inventory in a manner that expands homeownership, ensures a maximum return to the mortgage insurance fund, and strengthens neighborhoods and communities.

Criteria

Title 24 CFR part 291 requires that FHA issue policies and procedures to ensure the program's mission is met. It is responsible for the ongoing management, marketing, sales, and closing of acquired properties and management of custodial properties. FHA is also responsible for overseeing contractors and ensuring their compliance with contract terms. On-site reviews of contractor performance (including property inspections) and prompt enforcement action to correct deficiencies are important to the success of the program.

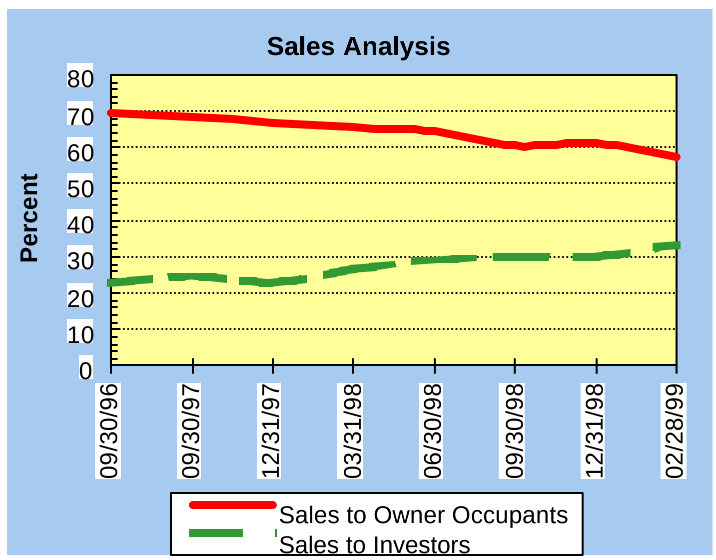
In its March 1998 report on the program, GAO stated that FHA did not have an adequate system in place to assess oversight of REAM contractors. GAO's property inspections identified serious problems including vandalism, maintenance deficiencies, and safety hazards. Similarly, in its March 1999 audit report on FHA's FY 1998 financial statements, KPMG cited various control weaknesses involving the property acquisition, management, and disposition functions, including inadequate oversight of REAM contractors. According to our audit results, these weaknesses continued through March 1999 to the detriment of HUD's mission.

Inventory increased

The property inventory increased 71 percent from about 24,800 properties on September 30, 1996, to about 42,300 properties on February 28, 1999. The inventory has increased by 3,200 properties since September 30, 1998. In comparison, the volume of total sales has not kept pace, increasing only 9 percent from about 58,500 properties in FY 1997 to 64,000 properties in FY 1998. There were about 26,700 properties sold in the first 5 months of FY 1999. At this pace, FY 1999 sales will not increase beyond the FY 1998 level.

Sales to homeowners declined

Although total sales were up slightly, monthly sales to homeowners steadily declined from 68 percent in September 1997 to 57 percent in February 1999. In contrast, monthly sales to investors increased from 25 percent to about 34 percent for the same period. Sales to nonprofit organizations increased from 7 to 9 percent during the period.



Program losses increased

Processing delays caused properties to remain in inventory longer, increasing property holding costs and increasing the potential for vandalism and decline in property values. Associated losses adversely impacted the program's mission of maximizing the return to the fund. Losses to the fund totaled about $269 million for FY 1997 and 1998. (See Finding 2.)

Neighborhoods and communities deteriorated

We found the program failed to strengthen neighborhoods and communities. This occurred because REAM contractors did not always secure, repair and maintain properties according to contract terms. Properties also remained in inventory longer than necessary causing them to deteriorate. In some cases, the FHA homes were the eyesore of the neighborhood.

We analyzed the results of 7,440 property inspections conducted between October 1998 and March 1999. We also inspected 48 acquired properties. The results were similar (See Appendix B); they showed systemic contractor noncompliance and many of the same problems identified by GAO. We compared the results of our inspections to recent inspection reports prepared by REAM contractors. We found numerous instances where the contractors did not include deficiencies in their reports. This condition was also identified by GAO.

Recent OIG and FHA inspections of acquired and custodial properties found deplorable conditions (See Appendix C).

The condition of FHA's property inventory has contributed to the program's performance problems including decreased marketability; increased holding costs; possible decreased value of surrounding homes; and in some cases, conditions that threatened the health and safety of neighbors and potential buyers.

Insufficient staffing and inadequate travel funds

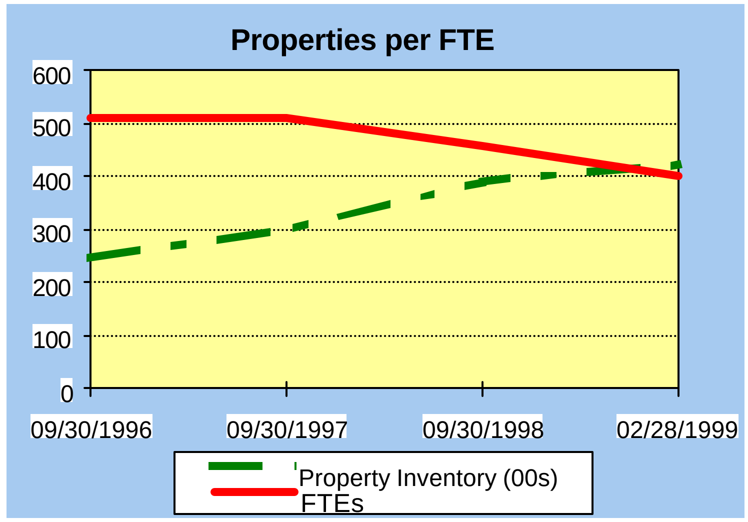
Staff shortages, inexperienced staff, increased workload, and limited travel funds prevented program employees from effectively overseeing program activities. As a result of HUD 2020 reforms, many experienced staff left HUD or took other HUD jobs. Buyouts and attrition depleted staff at a number of sites. Many of those remaining did not have program experience. FHA never intended that the remaining program staff would handle the full range of property management and disposition functions that we found them doing. FHA expected to award the M&M contracts by October 1998. However, the contracts were not awarded until January 1999 with March 1999 effective dates.

During our visit to the Santa Ana HOC in September 1998, we found that program staff could not handle the workload. Although the program was authorized 16 Housing Specialists, there were only 11 on duty. These 11 specialists were responsible for monitoring overall operations of 16 field offices located in 8 western states, including Alaska and Hawaii. In addition, because of staff shortages in the Los Angeles, Santa Ana, and San Diego field offices, the day to day property management, marketing, and contract monitoring duties for about 13,000 properties were transferred to the Santa Ana HOC. The staff's workload increased so much that staff from the Denver, Colorado and Tampa, Florida offices were sent to Santa Ana temporarily to help.

In Coral Gables, Florida, we found two employees working on the program. One of the employees had only been assigned for about a year. The other employee was in a clerical position prior to working for the program. Program officials confirmed that as a result of reorganization, many less knowledgeable and experienced staff were left in HOC's and field offices to handle the increased workload.

Staff shortages were also so severe in the Coral Gables, Florida; Jacksonville, Florida; Birmingham, Alabama; and Chicago, Illinois field offices that emergency contracts were awarded to handle most of their property disposition duties.

A long standing criticism of HUD's property disposition operation has been the unreasonable number of properties each FTE staff was expected to manage. According to the 1997 Andersen Consulting study, one FTE for 35 properties would be needed to effectively manage a portfolio similar to HUD's at the time of the study. We found that from September 30, 1996, to February 28, 1999, the number of properties per FTE increased from 48 to 106.



Planned staffing may not be adequate to manage the new M&M contracts. According to the Andersen study, if FHA's property disposition functions were completely outsourced, each field employee should be able to oversee the management and sale of 70 properties. It stated that a large number of properties per FTE could decrease FHA's ability to effectively monitor operations, and increase the possibility of fraud, waste, or abuse. FHA plans for 135 FTE in the HOCs and field offices to manage the contracts. At the current inventory level, this is about 300 properties per FTE. Each of the 28 program FTE under the Santa Ana HOC's jurisdiction will oversee about 580 properties.

In addition, many of the field staff assigned critical monitoring responsibilities only work for the program part-time. According to FHA's M&M Contract Monitoring Manual, these program support staff are responsible for performing sample property inspections and file reviews to assess the quality of contractor work. At the Santa Ana HOC's current inventory level, about 160 inspections and 160 file reviews are to be conducted monthly by staff. The Santa Ana HOC has 23 program support staff (7 FTE) assigned part time to perform this function in 8 states including Alaska and Hawaii.

Program officials in the field told us they did not have adequate travel funds in prior years to conduct reviews. HOC travel budgets and expenditures for FY 1999 (as of June 30, 1999) were:

	Budget	Expended
Atlanta	$209,943	$188,795
Denver	204,215	184,947
Philadelphia	222,842	196,032
Santa Ana	185,000	162,374
Undistributed	34,000	0
Total	$856,000	$732,148

In June 1999, the national program director said he did not have a breakdown of travel funds allocated HOCs property disposition activities for FY 1999. A Santa Ana program official told us that $17,000 had been allocated for property disposition activities in 8 western states including Alaska and Hawaii. An additional $54,000 was requested but had not been approved at the time of our review. These figures appear inadequate to protect the Government's interest; however, we were assured that adequate travel funds will be provided for program activities.

Inadequate contract monitoring

FHA Handbook 4310.5 REV-2 required FHA to perform an annual risk assessment of each REAM contract. Monthly on-site reviews were required for high risk contracts, quarterly for moderate risk contracts, and semi-annually for low risk contracts. The Handbook also required FHA staff to maintain control logs to record overall review results and target dates for correcting deficiencies. FHA was required to send written reports to the contractors, along with target dates for correcting deficiencies. All reports, including notes of oral guidance, were to be maintained in fully documented files to support contract extension decisions and act on inadequate performance.

In 1998, there were about 220 REAM contracts nationwide. If all REAMs were rated low risk, program staff were required to perform a minimum of 440 reviews annually or at least 880 during our 2-year review period. To assess whether program staff performed required reviews, we requested current control logs, all monitoring reports, and review checklists from January 1997. The HOCs provided evidence of 181 reviews, far short of the minimum required.

Our analysis also disclosed that staff did not perform monthly reviews on known high risk REAM contracts. For example, Atlanta's log showed that between July and December 1998, no reviews were conducted on any of the 10 contracts rated high risk. The Memphis, Tennessee office performed reviews of two contracts during April and May 1997. The staff rated one of the contracts low risk, and no rating was given for the second contract. Staff did not review these two contracts again until August 1998; by then they found both contracts to be high risk. Despite prescribed controls, no further reviews were done as of March 31, 1999.

There was also no standard reporting format. FHA staff often did not include risk ratings and target dates for correcting deficiencies in the reports. Most reports did not require contractor response. Many reports did not adequately describe the scope or the sample of properties or files reviewed.

We found that because of staff and travel fund shortages caused by HUD 2020 reforms, required property inspections were not always conducted by FHA staff. Even when inspections were conducted many were not reviewed or tracked to identify trends and systemic weaknesses. For example, although the Atlanta, Denver, and Santa Ana HOCs and field offices received thousands of inspection reports during this period, they did not compile and analyze the results. Occasionally some reports were reviewed and contractors contacted to correct problems on the individual properties. In Atlanta, we found hundreds of inspection reports in a desk drawer. In Santa Ana, we found hundreds more in a box. There was no evidence of any formal review or analysis of these reports.

Inadequate contract enforcement

Although contractor noncompliance was pervasive, FHA took few enforcement actions. Since January 1997, FHA did not assess any monetary penalties and only terminated four contracts for noncompliance.

For example, in July 1998, as a result of the OIG audit, the Philadelphia HOC began compiling inspection results. About 9,000 inspection reports were summarized and results reported quarterly to the HOC Director and to the Director of the Office of Insured Single Family Housing. The summaries showed 91 percent, 70 percent, and 78 percent of properties inspected during the 4th quarter of FY 1998 and the 1st and 2nd quarters of 1999, respectively, had one or more contract violations. Although the reports showed pervasive noncompliance, potential fraud, and deteriorated properties, little or no action was taken to enforce compliance. Several HOC officials told us that action was not taken against the contractors because the M&M contracts were expected to be awarded soon.

We requested correspondence from HOC officials and contracting officers to support any enforcement actions taken against REAM contractors since January 1997. We identified 52 contract actions during a 2-year period involving 39 contracts.

Letter of Concern	17
Cure Notice	26
Show Cause Notice	5
Termination	4
Total	52

Without timely on-site monitoring, management cannot assess contract performance and property conditions. In order for FHA to meet its mission, it is essential that adequate resources be committed at all management levels to monitor FHA staff and M&M contractor performance and enforce compliance as necessary.

FHA Comments

FHA generally agreed with our analysis of historical problems with its property disposition program. However, FHA disagreed with our concerns that planned staffing may not be adequate to manage the new M&M contracts. FHA stated that our conclusion was faulty because it was based on the Andersen Consulting study. FHA claimed the staffing estimates in the study were premised on the assumption that all REO work would be performed directly by HUD employees, not private sector contractors.

FHA also disagreed with our concerns regarding the adequacy of travel funds. It stated that allocation of travel funds at the HOC level empowers the HOC Directors to use travel funds to meet immediate work priorities, property disposition being the number one priority for the HOCs throughout this fiscal year. FHA also commented that under the new M&M initiative, FHA established an aggressive oversight program which included property inspections by a contractor and file reviews by third party auditors. Out-stationed HUD staff would also re-inspect 10 percent of the contractor's sample. FHA stated that these rigorous monitoring approaches would not tax current allocations.

OIG Response

Contrary to FHA's response, our citation of staffing estimates was based on the complete outsourcing of the property disposition function. The Andersen study states, "Industry also reports that if the PD function is completely outsourced, each employee should be able to oversee the management and sale of 70 properties." The study also recognized that based on an average inventory of 27,000 properties, the staffing level would need to be about 385 employees if the property disposition function was outsourced. A large number of properties per FTE could decrease FHA's ability to effectively monitor operations, and increase the possibility of fraud, waste, or abuse. As stated in the Finding, FHA plans for 135 FTE in the HOCs and field offices to manage the M&M contracts or about 300 properties per FTE. Also, each of the 28 program FTE under the Santa Ana HOC's jurisdiction will oversee about 580 properties. Thus, we remain concerned that the planned staffing will not be adequate to manage the M&M contracts.

FHA seems to contradict itself with the statement, ". . . these rigorous monitoring approaches would not tax current allocations." It would seem that travel allocations would be substantially affected if FHA intends to re-inspect 10 percent of the contractors' sample.

We remain concerned that if planned staffing and current travel allocations are not adequate, FHA will not be able to properly manage the M&M contracts. We will continue to assess FHA's ability to monitor contractor performance and enforce compliance.

Recommendation

We recommend that you:

1A. Ensure adequate resources are available (including staffing and travel funds at all organizational levels) to (a) monitor staff and contractor performance and enforce contract terms, and (b) take timely action when mission goals are not met.

FHA Incurred Millions in Unnecessary Property Holding Costs and Revenue Losses

Over the last 2½ years, FHA's ability to maximize return to the insurance fund was compromised. FHA was unable to meet its goals to sell properties within 5 months or at 98 percent of appraised value. In FY 1998, for example, almost half the inventory experienced processing delays when measured against industry standards. The delays occurred at various stages and were attributable to FHA staff, REAMs, and appraisers. As a result, properties remained in inventory longer and FHA incurred both an increase in its holding costs and a decline in revenue earnings from its program operations. Had FHA accomplished its goals, it would have contributed an additional $269 million to the fund in FY 1997 and 1998.

FHA seeks to minimize costs and maximize revenues. According to the Andersen study, FHA's goal is to sell properties within 5 months of acquisition and at 98 percent of appraised values. These goals are within industry standards. FHA measures performance using 10 standard processing steps, beginning with the acquisition and ending with the reconciliation of funds from the final sale or disposal of the property. SAMS tracks how many days properties are in a step and compares the actual time to a standard time. FHA also tracks various statistics, including the number of properties remaining in inventory over 6 months, the average number of days that sold properties are in inventory (holding period), appraisals, and sales prices.

Processing delays increased holding costs

The Andersen study showed that the processing time on 27 percent of FHA's inventory as of February 27, 1997, exceeded industry standards. On October 31, 1998, the number of properties exceeding standard processing time had increased to 44 percent. The following table shows where the delays occurred:

STEP	DESCRIPTION	STANDARD DAYS	% FAILING
1	Add property to inventory and assign REAM	17	64
2	Record appraisal of property	3	81
3	Determine method to dispose of property	3	16
4	Identify and approve repairs to property	20	34
5	Identify properties that are ready to list for sale	10	13
6	List property for sale	30	30
7	Accept preliminary offer for property	7	95
8	Accept sales offer/contract	60	31
9	Record sales or settlement of property	7	56
10	Close/archive property[6]		

[6] Processing time for step 10 is not tracked.

STEP	DESCRIPTION	STANDARD DAYS	% FAILING
	Total processing days	157	44

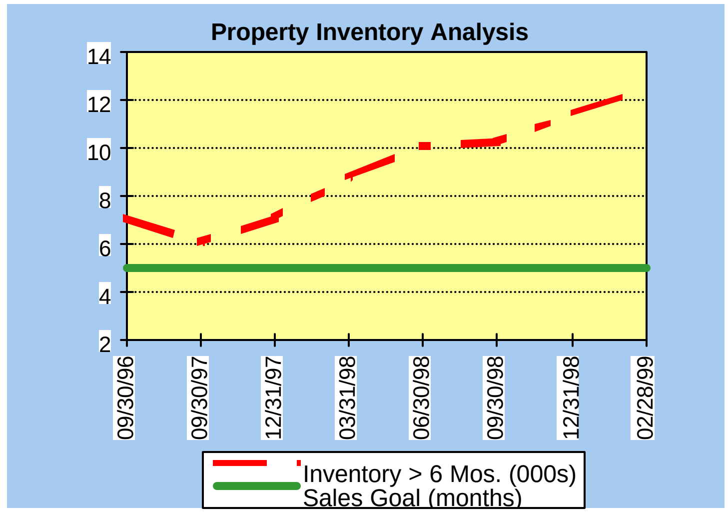
Our review of 38 case files showed similar results. All 38 cases showed delays attributable to one of the following areas:

- 31 percent of properties were not assigned to REAMs timely.
- 38 percent of properties were not assigned to appraisers or appraisals were not received timely.
- 29 percent of initial inspections were not performed or not received timely.
- No sales disposition programs were properly prepared or reviewed timely.

Total processing days are counted and averaged when properties are sold. In FY 1997 and 1998, average days from acquisition to sale was 182, or 32 days beyond the 5-month sales goal. These delays substantially increased FHA's holding costs. We calculated a daily holding cost per property using costs of staff, maintenance and operations, repairs, and lost interest and the average number of days sold properties were in inventory for FY 1997 and 1998. We determined that FHA's daily holding cost per property was $30.75 and $32.04[7], respectively. For the 2-year period, the delays increased losses to the insurance fund by about $123 million.

The first 5 months of FY 1999 showed no improvement - FHA missed its sales goal on average by 41 days. The average processing time on FHA sales will not improve quickly. This is because the overall age of the inventory has increased. The number of properties in inventory over 6 months increased 76 percent from 7,093 properties on September 30, 1996, to 12,503 properties on February 28, 1999.

[7] FHA's computation in November 1997 did not include applicable program costs such as property repair costs and all staff costs. Also, the calculation was improperly determined using average turnover rate (164 days) rather than average days in inventory (182 days), and ending property inventory rather than average inventory for the period.



FHA's inventory of properties over 12 months old is also in excess of industry standards. According to the Andersen study, the industry average for inventory over 12 months old is 2 to 3 percent of total inventory. FHA's monthly average was 7 percent in FY 1997 and 1998 and 9 percent for the first 5 months of FY 1999. Its goal is 5 percent.

FHA did not maximize return to the fund

FHA measures revenue losses based on the difference between average sales price and appraised value. It strives to sell properties at or near appraised value to maximize revenue to the mortgage insurance fund. The following schedule shows FHA's sales activity for FY 1997 and FY 1998. It reflects lost revenue totaling about $146 million because FHA did not meet its goal of selling properties, on average, at 98 percent of appraised value. It reflects a trend that continued into FY 1999.

		Average Sales Price				Sales	Revenue ($000,000)
FY	Appraisal	Actual	%	Goal	Difference	Volume	Gain/(Loss)
1996	$54,272	$ 53,449	98.5	$ 53,187	$ 262	53,000	$ 14
1997	$57,203	$ 55,589	97.2	$ 56,059	$ (470)	58,500	$ (28)
1998	$60,670	$ 57,606	94.9	$ 59,457	$ (1,851)	64,000	$ (118)
1999	$63,062	$ 59,700	94.7	$ 61,801	$ (2,101)	64,000	$ (134) *

* Annual projection based on sales through February 1999.

* * * * * * * * * * * * * *

During Congressional testimony in May 1999, the FHA Commissioner downplayed these statistics. Understandably, he preferred to focus on the fact that mortgage premiums offset property disposition losses by $1.5 billion in FY 1998. Considering FHA's inherent role in trying to bring homeownership to lower income families, it seems equally important, however, to find ways to reduce mortgage premiums. By maximizing revenue from sales and lowering costs, FHA could have returned $269 million more to the insurance fund in FY 1997 and 1998 than it did, a savings ultimately passed on to the borrowers. We recommend that the Commissioner stay equally focused on the program mission and performance goals.

FHA Comments

FHA disagreed with our conclusion that it incurred millions in unnecessary property holding costs and revenue losses. FHA stated the conclusion was blatantly false. FHA said that the performance goals cited in the report as the basis for our holding cost computation from the Andersen study were optimum REO performance measurements for the private sector. FHA claimed that it did not adopt these measurements as goals. Instead, it strives to sell properties in an average of 180 days rather than the 150 days. In reference to the losses, FHA stated that it recognized the importance of the statistics. It claimed that we misinterpreted the data and its goals and made erroneous conclusions.

FHA said it agreed with our recommendation to update performance goals based on current market conditions, program objectives, and the M&M contract structure; and to re-compute property holding cost factors.

OIG Response

The Andersen study was based largely on input from the Single Family Property Disposition Division. A FHA focus group known as the "Visioning Team" met to develop an "Operational Vision." The team compared its current property disposition process with that of industry. It redefined the property disposition mission, developed aggressive goals for the future, and identified key components of the future process, organization and technology that would enable attainment of future goals. It redefined the property disposition mission as follows:

> *"To reduce the inventory of acquired properties in a manner that ensures a maximum return to the Mutual Mortgage Insurance Fund (MMIF)."*

The team's Operational Vision states in part that,

> *"The Single Family Property Disposition Division will support the primary mission of the MMIF by maximizing the return from the sale of acquired properties, thereby making more and less costly FHA home loans available for those who are unserved or under-served by the private market."*

Using the results of the study, the team identified key performance indicators and target goals that would track program revenues and measure performance. One of the key performance indicators developed was "Sales Price as a Percentage of Market Value." The study states that, "The Team decided that 98% of a 30 day sale price is an appropriate target since industry generally prices for 30 day sale and industry's performance is 96-98% for unrepaired properties."

The team also identified Total Cycle Time (Average Holding Period) as a key performance indicator. The study had identified this as a primary indicator of cost efficiency since it directly impacts property holding costs. The study states that, "The Team set a Total Cycle Time target of 150 days by allocating 30 days for Evaluation, 60 days for Marketing (given a 30 to 60 day sale list price) and 60 days for Closing. This target is directly in the middle of the industry range of 120-180 days."

As stated in the study, the goals were developed in the spirit of the 1993 NPR and the requirements of the Government Performance and Results Act. The performance goals set out in the study were the only written goals we identified. Thus, we believe the audit report fairly reflects FHA's program goals and its inability to accomplish the goals it set and quantifies resulting losses to the insurance fund.

Interestingly, Andersen Consulting also recognized that FHA's failure to meet the goal of selling properties in 150 days could impact the insurance fund. Similar to our analysis, the study stated, "Attaining 150 days Average Holding Period may save the SFPD Division approximately $60.8 million annually in holding costs...".

Recommendations

We recommend that you:

2A. Develop and implement written procedures to routinely assess whether program mission goals are achieved and take corrective action when goals are not met.

2B. Recompute and track the per property holding costs based on industry-recognized program costs when the M&M contracts and monitoring contracts are fully implemented.

Controls Over M&M Contracts Need Strengthening

HUD's new M&M contracts and contract monitoring policies are comprehensive, but need some improvement. We found that contracts did not contain (1) sufficient information regarding FHA's reimbursement to contractors for property repair costs, or (2) monetary penalties for contractor noncompliance. In addition, the new contract monitoring manual did not provide comprehensive guidance to review and approve reimbursement of repair costs, conduct contract risk assessments, and document monitoring results. Clarity and consistency in applying policy is needed to prevent contractor noncompliance and abuse.

M&M Contracts

On March 29, 1999, 16 M&M contracts went into effect with a 5-year value of about $927 million. The seven companies that received these contracts will manage nearly every aspect of the property disposition process from property acquisition and maintenance to marketing and sales. In general, FHA pays contractors an initial fee when they list properties for sale. This fee is determined by multiplying a contract price factor by the list price. The result is multiplied by 30 percent. For example, $80,000 (list price) x 3.5 percent (price factor) x 30 percent = $840. A final payment is made when the property is sold. It is based on the net sales price. For example, $75,000 (net sales price) x 3.5 percent (price factor) less $840 (first payment) = $1,785. FHA also pays a fixed amount per month (e.g., $95 per property) for managing its custodial and unimproved properties.

Costs for most services between acquisition and sale are built into the fees and paid by the contractors. These include costs for such services as the appraisals, debris removal, and advertising. This system provides an incentive for contractors to sell properties quickly at prices that provide the most return for them and FHA. The lower the contractors' costs; the higher their profits.

In addition to fees, FHA also reimburses contractors for other costs incurred. These "pass-through" costs are primarily third-party charges such as for taxes and utilities. Under certain circumstances, some property repair costs are reimbursable with FHA's prior approval. These include costs of repairs for:

- natural disasters,
- extraordinary acts of vandalism,
- mortgagee neglect,
- remediation of environmental hazards,
- latent defects to properties not reasonably detectable, and
- major deficiencies not related to normal maintenance when properties are received by contractors (e.g., repairs for properties to meet Minimum Property Standards (MPS)).

We found the contracts provided little information to contractors regarding when and how these costs are to be reimbursed. Program officials told us that FHA staff will rarely approve payment for property repair costs under any circumstances. One official said that FHA will not reimburse contractors for MPS related repairs. Properties are generally sold "as is." The official stated that if properties are insured, funds to pay needed repairs will be included in an escrow account at closing or contractors will pay for the repairs.

Failure to provide contractors enough information about the reimbursement of repair costs may lead to confusion and abuse. For example, our review of one contractor's draft quality control plan found extensive steps devoted to assessing properties for needed MPS repairs, obtaining FHA authorization, and initiating action to make the repairs. An official in the Santa Ana HOC stated that depending on the circumstances, MPS related repairs will be authorized. Reimbursement of repair and maintenance costs has been subject to fraud and abuse in the past. FHA has tried to reduce the problem in these contracts by including most costs in contractors' fees and requiring prior approval for reimbursement of other costs.

The contracts contain no provision for monetary penalties if contractors fail to comply with contract terms. Program officials told us they did not believe monetary penalties are necessary because most property management and marketing costs are included in the fees. They believe that extensive noncompliance and abuse under the prior property disposition process should be significantly reduced. Officials said that there are provisions in the contracts for termination, if necessary.

Our review disclosed that during the last 2 years FHA rarely sanctioned REAM contractors although noncompliance was pervasive. No monetary penalties were imposed and only four contracts were terminated. We believe the M&M contracts should contain specific monetary penalties (e.g., liquidated damages clause) to help ensure compliance and to offset losses to the fund caused by the contractors.

M&M Management Control Manual

FHA designed an extensive manual entitled M*anagement Controls For The Single-Family REO M&M Contracts* covering contract management, financial, and monitoring controls. If FHA properly implements and consistently follows the manual, most of the contract management problems shown in Findings 1 and 2, should be eliminated. However, several areas of the manual need strengthening to ensure its effectiveness.

Except for the review and approval of repair of latent defects, the new manual has no policies or procedures to approve, justify, and document FHA payment of other repair costs. For example, there is no definition in the manual of what constitutes extraordinary vandalism and no requirements for contractors to justify reimbursement of the costs (e.g., police report). The contracts state that all repairs caused by ordinary vandalism (broken windows, graffiti) are not reimbursable.

The manual provides numerous standard review instruments for FHA staff to use in monitoring contract activities. For example, there are 94 pages of review documents for conducting risk assessments on each of 11 critical events (e.g., mortgagee claims, property inspections, appraisals, sale closings). A low risk rating requires that the contractor acknowledge any deficiencies and correct them. A medium rating requires a reprimand, suspension, or termination of key personnel or subcontractors. A high risk rating requires issuance of a cure notice placing the contractor on probation or contract termination. The manual also requires that an overall risk assessment be made on each contract. Contractors are to be given the assessments, required to respond, and take corrective action.

However, the manual is not clear on how often all documents should be completed and there is no standard document or procedures for conducting the overall assessment. Each critical event is weighted equally. Therefore, a high risk rating on a contractor’s handling of property maintenance is weighted equally with a high risk rating on its handling of rental properties. A program official in FHA’s national office told us that all forms must be completed and an overall risk rating made monthly on each contract. A Government Technical Representative responsible for oversight of one of the contracts said he did not know how often the assessments should be conducted.

The manual requires that a final assessment report must be prepared each month on each contract. The report must contain a performance/risk assessment, contractor’s response, and FHA’s determination of corrective action. This report is to be sent monthly to the HOC Director, the Deputy Assistant Secretary for Single Family Housing, and the FHA Commissioner. However, there is no standard format for the report and no requirement that it be sent to the contracting officer who is the only person who can sanction contractors. Also, the manual does not provide sufficient details regarding what documentation is needed and what specific actions to take when contractor sanctions are necessary. Although program officials told us that verbal procedures have been established for working with the contracting officers, we believe that written guidance is necessary.

FHA Comments

FHA generally agreed with the finding and recommendations. FHA stated that it should provide additional guidance to staff regarding reimbursements to M&M contractors for property repairs. It agreed to revisit the potential for incorporating monetary penalties for contractor noncompliance and to strengthen its monitoring approaches.

Recommendations

We recommend that you:

3A. Issue detailed written policies and procedures for approving reimbursement and documenting the need for repairs associated with natural disasters, extraordinary vandalism, mortgagee neglect, environmental hazard remediation, latent defects, and MPS.

3B. Modify the M&M contracts to require monetary penalties (e.g., liquidated damages) for specific recurring contract deficiencies.

3C. Revise the M&M management control manual and/or issue written policies and procedures:

(1) detailing how often risk assessments must be made for all critical events and providing a standard document for completing the overall risk assessment including risk rating weights for each event; and

(2) providing a standard document for completing the monthly final assessment report and requiring that copies be sent to applicable contracting officers.

3D. In conjunction with contracting staff, issue written policies and procedures specifying what actions to take and documents needed to enforce compliance and sanction deficient contractors.

3E. Develop a system to track and summarize monitoring results to identify trends and systemic weaknesses for corrective action.

Follow-up on Prior Audits

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

- An OIG audit (Report Number 96-BO-123-0001, dated June 1996) of the Massachusetts State Office concluded that FHA had not established and implemented adequate management controls to monitor and assess performance of REAM contracts.

- An OIG audit (Report Number 97-SF-123-0802, dated July 23, 1997) of the Arizona State Office found that program staff did effectively monitor a REAM contractor's performance resulting in payments for work not performed.

- An OIG audit (Report Number 98-AO-123-0001, dated January 30, 1998) of the pilot contracts conducted soon after the contracts were awarded, identified several weaknesses. Except for an issue regarding SAMS data, adequate corrective actions were taken. A subsequent OIG audit of SAMS (Report number 98-DP-166-0004, dated September 30, 1998) found a similar problem. The findings of this report did not impact our audit objectives.

- A GAO audit (Report Number 98-65, dated March 27, 1998) of FHA's management of REAM contractors in Boston, Chicago, and Fort Worth concluded that FHA did not have an adequate system in place to monitor oversight of REAM contracts.

- An audit of FHA's 1998 financial statements, performed by KPMG, LLP (Report Number 99-FO-131-0002, dated March 12, 1999) concluded that, "FHA has control weaknesses in its single family property acquisition, management and disposition functions which hindered FHA's objective to reduce inventory in a manner that maximizes the return to the mortgage insurance funds while preserving and protecting residential properties."

As discussed in detail in the "Findings and Recommendations" section of this report, these conditions regarding contract monitoring continued to exist. HUD 2020 reforms inhibited proper implementation of effective corrective actions. This report stresses the importance of developing and implementing management controls to ensure that the conditions do not continue.

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Locations Visited

DESCRIPTION	**LOCATION**
Single Family Housing Division	**Washington, DC**
Homeownership Center	**Atlanta, Georgia**
Field Office	**Chicago, Illinois**
Field Office	**Coral Gables, Florida**
Homeownership Center	**Denver, Colorado**
Field Office	**New Orleans, Louisiana**
Homeownership Center	**Philadelphia, Pennsylvania**
Homeownership Center	**Santa Ana, California**
Contractors	
The Urban Group (REAM)	**Ft. Lauderdale, Florida and Miami, Florida**
Gibralter Realty, Inc. (REAM)	**Chicago, Illinois**
Golden Feather Realty Services, Inc. (Pilot M&M)	**New Orleans, Louisiana**
Citiwest Properties, Inc. (Emergency M&M)	**Coral Gables, Florida and Chicago, Illinois**

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Results of FHA Property Inspections

October 1998 through March 1999[8]

Field Office[9]	Inspections	Percent Deficiencies: Debris Outside	Debris Inside	Property Unsecured	Defective Paint	Vandalism	No FHA Sign	No Regular Inspections
Atlanta	32	19	41	0	23	16	4	31
Chicago	1,123	12	23	18	6	21	5	20
Coral Gables	105	38	22	9	89	22	15	14
Philadelphia[10]	5,977	24	20	16	27	0	14	16
Santa Ana	203	15	9	5	7	32	29	15
TOTAL	**7,440**	**22**	**20**	**16**	**22**	**5**	**13**	**17**

Results of OIG Property Inspections

August 1998 through March 1999

Field Office	Inspections	Percent Deficiencies: Debris Outside	Debris Inside	Property Unsecured	Defective Paint	Vandalism	No FHA Sign	No Regular Inspections
Atlanta	6	50	83	33	50	50	16	50
Chicago	11	45	64	9	88	45	45	0
Coral Gables	9	44	22	56	20	13	100	100
New Orleans	12	42	42	17	65	25	100	86
Los Angeles	5	40	20	0	11	40	100	25
Santa Ana	5	80	60	20	10	0	40	0
TOTAL	**48**	**48**	**49**	**23**	**46**	**28**	**68**	**47**

[8] Except for Philadelphia HOC summaries, we did not review all inspection reports or summaries prepared during the period by or for these offices.
[9] Although inspection reports were requested from the Denver HOC, none were provided.
[10] All field offices in the Philadelphia HOC's jurisdiction.

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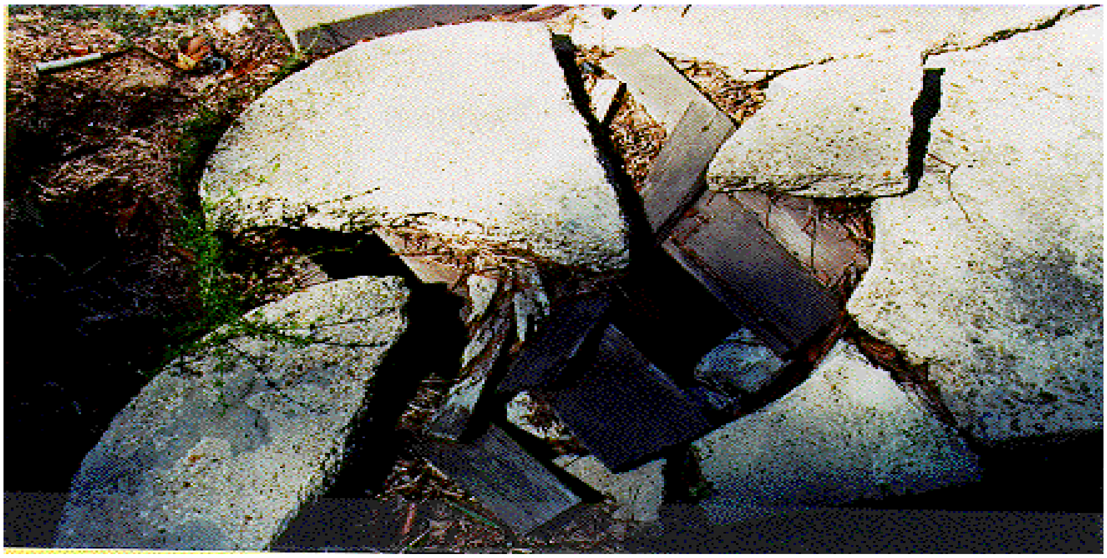
Examples of Acquired and Custodial Property Conditions



Acquired November 1998 FHA Case Number 221-127722 New Orleans, Louisiana
OIG Inspection March 16, 1999

This well was not secured by the REAM; a major safety hazard.

Acquired March 1998 FHA Case Number 131-799500 Rockford, Illinois

The REAM did not repair the roof causing the ceiling to fall.

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Acquired June 1998 FHA Case Number 041-856326 Los Angeles, California
OIG Inspection March 13, 1999

The REAM did not maintain the yard.

Acquired January 1999 FHA Case Number 221-272693 New Orleans, Louisiana
OIG Inspection March 16, 1999

Exterior not free of debris; a REAM responsibility.

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Acquired July 1996 FHA Case Number 092-446893 Ft. Lauderdale, Florida
OIG Inspection January 19, 1999

Ceiling has fallen from water damage caused by a roof leak. No repairs were made by the REAM.

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Custodial Property FHA Case Number 221-154121 New Orleans, Louisiana
Assigned November 1996 OIG Inspection March 17, 1999

Yard full of debris. Grounds were not maintained by the REAM. This condition adversely impacts the neighborhood and is a potential safety hazard.

Custodial Property FHA Case Number 132-070682 Petersburg, Illinois
Assigned June 1996 FHA Inspection December 15, 1998

Trash and other debris not removed by the REAM. The condition adversely impacts the neighborhood, and it is a potential safety hazard.

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Custodial Property FHA CASE Number 132-069554 Alton, Illinois
Assigned May 1995 FHA Inspection December 10, 1998

The condition of this property adversely impacts the neighborhood.

Same property as above.
The REAM contractor did not properly secure the property; a potential safety hazard.

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Custodial Property FHA Case Number 132-054460 East St. Louis, Illinois
Assigned November 1993 FHA Inspection December 10, 1998

Water damage caused by the REAM not repairing the roof.

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FHA Comments

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

SEP 2 1999

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

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

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

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

Thank you for the opportunity to review and comment on your audit report on the Single Family Property Disposition program. The audit assesses program activities from October, 1996 through March 1999 and was performed by OIG staff from August, 1998 through April 1999 – a period of time when FHA was in transition from directly administering FHA's property disposition program, to outsourcing with private sector professionals. On March 29, 1999, FHA implemented the cornerstone of the HUD 2020 reform plan for single family property disposition, the Management and Marketing (M&M) contract initiative. Therefore, this audit is primarily focused on assessing program performance prior to the implementation of HUD 2020 reform, though it also includes a review of new contract management and control procedures developed by FHA in consultation with Booz-Allen & Hamilton for the new M&M environment.

The audit accurately notes a history of problems with FHA's property disposition program, citing a series of OIG and GAO reports conducted over the last several years, prior to the implementation of HUD 2020 reforms. The audit also accurately indicates that the pilot contracts for the new Management and Marketing approach were the subject of another prior OIG audit. In fact, FHA and OIG staff met nearly every week during the M&M pilot and worked together to construct a revised, model contract to address deficiencies in the pilot. This model, which incorporates every one of the recommendations of the previous OIG audit, is the basis for the new M&M contracts. Too often in the past, responses to prior OIG audits have resulted in short-term solutions which did not address inherent program weaknesses. Here, I believe the new M&M contracts developed with significant input from the OIG, has enabled the Department to finally free itself from the burden of an inefficient organizational structure.

While I am concerned that the report contains several false and misleading statements and relies in several instances on faulty methodological approaches to assess prior performance, I am pleased that the Office of the HUD Inspector General (OIG) shares my belief that the new Management and Marketing approach to FHA's single family property disposition will address many of HUD's long-standing program deficiencies. I agree with the conclusion of the audit which states that, "if FHA properly implements and consistently follows its manual [*Management Controls For The Single Family REO M&M Contracts*], most of the contract management problems shown in Findings 1 and 2 should be eliminated". As the audit notes, FHA has developed a comprehensive set of program management and control procedures to ensure effective monitoring of the new M&M contractors. We are aggressively implementing the procedures and controls identified in that manual and it is paying dividends. Contrary to concerns expressed in the audit that FHA will not act promptly to enforce sanctions when contractor performance is inadequate, we are aggressively monitoring M&M contractors' performance. The strongest evidence of this is that FHA terminated contract services under one of the 16 M&M contracts, ***30 days into performance under the contract***, due to performance issues. Moreover, FHA also issued six "cure" notices for other contract areas within the first ninety days of the new initiative.

FHA also disagrees with OIG's claim that current REO staffing levels under the M&M environment are not sufficient. FHA commissioned Booz-Allen & Hamilton to conduct detailed work flow and staffing analysis to address FHA's staffing needs under the M&M environment. FHA has ***exceeded*** the staffing levels recommended in Booz-Allen & Hamilton's January 22, 1999 report, recognizing the unique demands of the transition and initial implementation periods.

The draft audit report states "planned staffing may not be adequate to manage the new M&M contracts". The basis for OIG's faulty conclusion here appears to be drawn from 1996 study by Andersen Consulting, commissioned by FHA to review private industry practices and identify means by the Department could best improve its internal operations. Ultimately FHA determined that it could not match the skills and flexibility of the private sector, and as noted above, that ***outsourcing*** property maintenance and sales is the best approach for FHA. The Anderson study was a valuable tool in gathering information about private sector capacities, but its staffing estimates were premised on the assumption that all REO ***work would be performed directly by HUD employees***, not private sector contractors. Booz-Allen & Hamilton used information from the Anderson study for its analysis, but identified staffing requirements for the ***outsourcing*** approach, and emphasizes contract administration and oversight.

FHA also appreciates OIG's sound recommendation that management should provide additional guidance to FHA contract monitoring staff regarding reimbursements to M&M contractors for property repairs. As the audit notes, FHA solicited input from OIG in developing the M&M contracts and incorporated every one of OIG's recommendations into the final contract, including a dramatic reduction in the number of eligible pass through expenses.

Furthermore, FHA will follow OIG's new recommendation to revisit the potential for incorporating monetary penalties for contractor non-compliance with HUD requirements. FHA staff previously discussed the potential value of monetary penalties with HUD contracting staff prior to implementing the M&M contracts, and were advised that such provisions were not necessary since the M&M contracts are performance-based contracts, where non-performance on critical services adversely impact the contractors themselves. However, FHA will discuss options for inclusion of non-performance penalties, including liquidating penalties, with Departmental experts on contract approaches. FHA also agrees that our monitoring approaches will be strengthened by standardizing a reporting format, clarifying risk assessments, and identifying performance trends.

OIG's Assessment of Prior Performance

I am pleased that the OIG abandoned the ill-conceived analysis contained in the preliminary audit report to Congress that suggested that the Department was wasting a "million dollars a day" in taxpayers money on its REO sales operation. As you know, that unfounded accusation was the centerpiece of a Congressional hearing and a national television news broadcast. Even though the final audit backs away from this erroneous claim, the preliminary report nevertheless did substantial harm to the reputation of the FHA, and may have contributed to a loss of revenue as private entities lost confidence in our products. I am therefore pleased that the final audit does not include this erroneous claim.

The final OIG audit does however state that FHA incurred millions in unnecessary property holding costs and revenue losses. This conclusion too is patently false. OIG appears to reach this conclusion by comparing FHA's REO sales performance for 1997 and 1998 to optimum industry standards identified in the 1996 Arthur Andersen study. The Department simply did not adopt the goals cited in the OIG audit. These measurements are included in the Anderson study as optimum performance measures for the private sector REO industry, based on the 1996 real estate market. They do not reflect the Department's social mission, including sales to owner-occupants, nonprofit organizations and local governments. Furthermore, it is not realistic to expect a public agency encumbered with the regulatory constraints and stringent civil service restrictions to perform at the optimal level for private industry.

Instead, FHA strives to sell HUD-help properties in an average of 180 days, within range of the private industry standard which Andersen Consulting identified as between 150 and 180 days in inventory, but not equal to the optimal or peak private sector performance. As noted in the draft audit, FHA average sales in FY 1987 and 1988 was 182 days, only slightly above expectations. The 150 days in inventory goal identified by OIG in the audit is not FHA's internal goal, nor is it a realistic expectation under the old method of REO property disposition which is the subject of this audit. Therefore, OIG's entire basis for asserting that FHA's REO operation is losing revenue is faulty.

OIG also seems to have misinterpreted the intent behind edits imbedded in FHA's primary computer system for REO property inventory control, SAMS. SAMS tracks the status of properties from conveyance through sale and closing, using 10 distinct "steps" in the disposition process. When properties remain in a step past a selected time period, disposition specialists must review the account to determine if additional action is required. The OIG audit erroneously identifies the total days in step (157) as a standard. The "tickler" at the end of each step time period is not a goal, as OIG appears to assume, but rather it is a process flow management tool intended to highlight properties in need of focused attention.

Furthermore, the audit states that "During Congressional testimony in May, 1999, the FHA Commissioner downplayed these statistics" . Quite to the contrary, I recognize both their importance and complexity. Although misinterpretations of the data by OIG staff lacking program or industry knowledge are understandable, misrepresentations of performance goals and erroneous conclusions on this issue are both misleading, and detract from genuine efforts to improve program performance. However, I do embrace the practical recommendation offered in the draft audit, that FHA update performance goals based on current market conditions, program objectives, and the M&M contract structure; and that property holding cost factors be re-computed.

The OIG audit also inaccurately cites as the cause of a growing portfolio insufficient staffing, inadequate travel funds, inadequate contract monitoring, and inadequate contract enforcement. Again, inherent deficiencies in the former disposition approaches did contribute to the problems listed above. However, the audit fails to recognize that economic and market conditions drove both an increase in property acquisitions and a sluggish resale market. Furthermore, a key advantage to FHA's new outsourcing approach is the ability of the private sector to swiftly expand and contract its workforce based on market conditions, and to foster expertise in skills not readily found in the federal workforce. Our recent experience with successful private sector contractors reveals that a relatively small, centralized disposition workforce relying on a strong network of local service providers can be extremely effective. *Conversely, contractors who most closely mimic FHA's prior disposition* approaches but utilize a significantly larger staff have been far less successful.

The adequacy of travel funds is a recurring concern in the draft audit. The draft identifies FY 1999 travel budget and expenditures for the Single family Home Ownership Centers. The allocation at the HOC level empowers the HOC Directors to use travel funds to meet immediate work priorities, property disposition being the number one priority for the HOCs throughout this fiscal year. The draft report states that "These figures appear woefully inadequate to protect the Government's interest". The draft contains no analysis to support this conclusion.

Under the new M&M initiative, FHA has established an aggressive oversight program which includes on-site property inspections of 10 percent of its portfolio each month by "special property inspectors" – private firms with property maintenance and inspection expertise, and review of 10 percent of all property files using third-party auditors. Out-stationed HUD staff re-inspect 10 percent of this sample as a primary control over HUD-held property and file conditions. Through this approach FHA once again maximizes the use of a private industry network of service specialists, and ensures contract compliance using on-the-ground FHA staff. None of these rigorous monitoring approaches tax current travel allocations.

As a final clarification, the Management and Marketing contracts do represent FHA's primary current means of disposing of properties. However, recent legislation has provided FHA with two new authorities representing alternative disposition strategies. FHA is negotiating pilot agreements with local communities to sell properties in "Asset Control Areas" to local governments and non-profits on a future flow, or "pipeline" basis. FHA has also initiated efforts to acquire and sell FHA-insured mortgages in default, in lieu of acquiring properties.

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