U.S. Department of Housing and Urban Development
Pacific/Hawaii
Office of Inspector General for Audit
450 Golden Gate Avenue, P.O. Box 36003
San Francisco, California 94102-3448

April 25, 1996

Audit-Related Memorandum
96-SF-123-0804

MEMORANDUM FOR: David A. Westerfield, Director, Single Family Division, Santa Ana Area Office, 9JHS

FROM: Gary E. Albright, District Inspector General for Audit, 9AGA

SUBJECT: Review of Santa Ana Area Office's Property Disposition Branch Santa Ana, California

INTRODUCTION

In response to a January 17, 1996 Congressional request to the Secretary of HUD, we reviewed the operation of HUD's Santa Ana Area Office (SAAO) Single Family Property Disposition (SFPD) Branch. The purpose of our review was to evaluate whether the concerns contained in the request could be substantiated. We separated the concerns into the following categories:

- Single family acquired properties that did not meet minimum property standards (MPS) were sold with FHA insurance;
- Appraisal procedures used in establishing property fair market values were inappropriate;
- Homebuyers were required to pay higher move-in costs for properties purchased from the SAAO than for those purchased from other HUD field offices; and
- Procedures for handling bid offers and results were ineffective and inconvenient.

SUMMARY

Our review disclosed that the various concerns of potential mismanagement were unsubstantiated except that the SAAO allowed 10 of 114 properties reviewed to receive FHA insurance even though they did not meet minimum property standards. The issues stemmed largely from a comparison of differing property disposition practices between several HUD, SFPD Branch offices. Because economic conditions vary between localities, HUD designed the SFPD Program to give each field office discretion in structuring its disposition program to best manage and sell its properties. Therefore, differences between field offices in the administration and sale of single family acquired properties can be expected; however, those differences do not necessarily mean there has been a violation of HUD regulations or requirements so long as any HUD Headquarters limitations were not exceeded.

We believe, however, that the SAAO can better manage its SFPD program by increasing its use of sales incentives to market its properties, and improving sales and bid handling procedures that deliver greater client satisfaction. In our opinion, increasing the use of these sales incentives will not only improve the public's image of HUD's home ownership program but will also increase the salability of the properties. This, in turn, will reduce the SAAO's inventory in a manner that expands home ownership opportunities and strengthens neighborhoods and communities. In addition, it may also provide a maximum return to the mortgage insurance fund.

We also recognized that, given the high sales goal of 6,249 properties established by HUD Headquarters for just the first eight months in Fiscal Year 1995, the Single Family Property Disposition Branch was understaffed. At the time of our audit, the SAAO had only 17 staff people working in the branch, whereas the Los Angeles Area Office's Property Disposition Branch had 11. That office may also be understaffed even though its goal was only 2,687.

We discussed the results of our review with SAAO officials during the audit and at an April 9, 1996 exit conference. On April 11, 1996, we provided SAAO officials with a copy of the draft finding for their comment and we received their written response on April 15, 1996. They generally agreed with the finding and recommendations and their comments are included in the finding.

BACKGROUND

HUD acquires single family properties (one-to-four family residential units) from foreclosure of FHA-insured mortgages or special acquisitions. Following foreclosure, mortgage lenders have the right to deed the properties to HUD in exchange for mortgage insurance benefits.

Single Family Property Disposition activities are largely decentralized, with field offices having day-to-day responsibility for individual properties. Upon acquiring a property, the field office assigns the property to a Real Estate Asset Manager and an appraisal is ordered. When the property is ready for sale, it is generally offered for a 10-day period on an open listing, subject to competitive sealed bid procedures. Real estate brokers are actively encouraged to participate in HUD's Single Family Property Disposition Program. Private closing agents are contracted to perform the settlements.

Property appraisals to determine the fair market value of acquired properties were being contracted out with Strategic Management Services (SMS). This private contractor has a HUD contract to perform property appraisals for newly acquired single family properties nationwide. SMS appraisers used statistical data to identify properties comparable to the subject property. Three comparables that were sold within the last six months plus two others that were only being listed for sale were generally being used as a basis for establishing the fair market value. The appraisers make site visits at the subject property as well as the comparable properties. The appraisers also include a determination as to whether the property can be sold with FHA insurance in its present condition without repairs. If not, the appraisers make a list of needed repairs and estimate the costs of those repairs needed to bring the property up to MPS so as to qualify the property for FHA insurance.

Acquired properties are primarily sold through weekly public bid openings. Real estate brokers submit bids on properties contained in weekly sales listings on behalf of their clients, by mailing, faxing, or hand carrying the bids directly to the SAAO office. Bid results are posted to computer bulletin boards and an automated phone system about two days after the bid opening date.

The SAAO also used auctions to sell properties that were aged, or were considered hard to sell. The SAAO holds auction sales about every three months. About one-third of the 4,897 properties sold by SAAO between February 1, 1995 and January 31, 1996, were sold through auction sales.

A repair escrow program is available for properties which need less than $5,000 in repairs to meet MPS so as to qualify the property for FHA insurance. The cost of making the repairs is paid by HUD from sales proceeds, but the money is put into escrow with the lender until the homeowner completes all of the repairs. The lender is responsible for making sure that the property owner completes all the needed repairs before releasing the money from escrow. The SAAO currently does not offer this program to its participants. The SAAO, however, offers the Section 203k Program, which allows a buyer to obtain one insured mortgage loan to finance acquisition and repair of a property that needs a minimum of $5,000 in major repairs.

According to a June 1995 FHA Commissioner's executive report, HUD had established a goal to sell 60,135 single family HUD-owned properties during the first eight months of Fiscal Year 1995. During that period, HUD actually sold 41,651 properties. Of those amounts, the SAAO had a goal to sell 6,259 (10 percent of the national goal), and actually sold 3,845 properties (nine percent of the actual national sales).

OBJECTIVE, SCOPE AND METHODOLOGY

The overall objective of our review was to evaluate whether the concerns of potential mismanagement contained in the January 17, 1996 request could be substantiated. To accomplish this objective we: (1) interviewed SAAO officials and staff; (2) contacted real estate brokers that sold HUD-acquired properties; (3) contacted or visited homeowners that bought SAAO properties; and (4) reviewed property case files and other records relating to the SAAO's Single Family Property Disposition Branch operations.

The audit generally covered the period January 1 through December 31, 1995, but we extended our review to other periods when appropriate. We performed the field work between February 6 and March 22, 1996.

REVIEW RESULTS

<u>The SAAO Can Improve Its Administration of the Single Family Property Disposition Program</u>

The SAAO can better manage its Single Family Disposition (SFPD) Program by increasing its use of sales incentives to market its properties and by improving sales and bidding procedures so as to deliver greater client satisfaction. The decentralization of the day-to-day responsibility for the disposition of individual properties provides field offices with several options to market their inventory. Sales incentives available to the Property Disposition Offices include: (1) lower downpayment options from 3% to as low as $100 and (2) property repairs using repair escrows for damages of less than $5,000 or use of Section 203k financing for properties needing a minimum of $5,000 in major repairs. To some extent, the SAAO has not taken full advantage of these sales incentives. In our opinion, use of these sales incentives will not only improve the public's image of HUD's home ownership program but will also increase the salability of the properties. This, in turn, will reduce the inventory in a manner that expands home ownership opportunities, strengthen neighborhoods and communities, and may also provide the maximum return to the mortgage insurance fund. In addition, improved sales and bidding procedures that are convenient to brokers and homeowners participating in the program could provide greater client satisfaction.

1. Use of Sales Incentives

a. <u>Lower downpayment may attract more potential buyers.</u>

HUD Handbook 4310.5 REV-2, *Property Disposition Handbook One to Four Family Properties,* Paragraph 10-7.C. states that downpayment requirements will normally be consistent with the Section of the National Housing Act under which the mortgage is to be insured. If determined to be necessary to stimulate sales, the downpayment may be established at three percent of the bid amount. Where further reductions below three percent are essential to sales of properties, the downpayment may be reduced for temporary periods, to as low as $100, as long as any HUD Headquarters limitation is not exceeded.

Currently, the SAAO requires a four percent downpayment for owner-occupants that obtain an FHA-insured loan greater than $50,000 to purchase SFPD acquired properties. Generally, a three percent downpayment is required for a regular FHA loan. According to SAAO officials, the higher downpayment was required in order to decrease the loan default rate; however, they did not have any evidence to support that conclusion. We believe that easing the minimum downpayment requirement would not significantly impact the loan default rate. Further, the lower downpayment requirement could attract more potential buyers, thereby increasing the salability of the properties.

Between February 1, 1995 and January 31, 1996 the SAAO listed 10,604 properties for sale but only received offers on 5,285 (50 percent) of those properties. Since HUD's goal is to ensure rapid turnover of acquired SFPD properties and a maximum return to the insurance fund, we believe that the SAAO could improve the salability of its properties by lowering its owner-occupant downpayment requirement. A SAAO official, however, stated that one of the reasons for receiving offers on only 50 percent of the listings was the large number of properties being offered where buyers were unable to consider all the properties that were listed.

In order to get an idea as to how some of HUD's clients feel about the size of the downpayment required to purchase a HUD acquired property, we surveyed 20 real estate brokers that sold HUD acquired properties. Although the brokers generally thought that the four percent downpayment requirement was not excessive, 17 of 20 brokers (85 percent) told us that a lower downpayment requirement would attract more potential buyers; therefore, the number of property sales would increase.

We also surveyed 15 homeowners that purchased properties in 1995 to determine whether they had any difficulty meeting the downpayment requirement. Overall, the homeowners said that while they were able to save enough money for the downpayment, it adversely impacted their ability to pay for repairs needed on the properties after they made the purchase. This was particularly true for properties purchased from the SAAO because, as a policy, most of the SAAO's acquired properties were sold without making any repairs. Two homeowners had difficulty in obtaining the required minimum four percent downpayment and had to borrow from friends or relatives.

b. <u>Properties not meeting Minimum Property Standards (MPS) were sold with FHA insurance.</u>

HUD Handbook 4310.5 REV-2, *Property Disposition Handbook One to Four Family Properties,* Paragraph 6-19, states that properties should be sold as insured if HUD believes, that in their present condition, the properties meet the intent of the Minimum Property Standards (MPS). Properties which need less than $5,000 worth of repairs to meet the intent of MPS, will be offered for sale with mortgage insurance available, provided a cash escrow is established to ensure the completion of repairs. Paragraph 10-8(A) further states that this is intended to be the Department's primary repair tool and Field Offices are encouraged to make it available for properties which qualify.

To emphasize HUD's resolve in expanding home ownership opportunities, a November 1995 letter from the Assistant Secretary for Housing-Federal Housing Commissioner to all mortgagees emphasized that its repair escrow program was an important component of HUD's efforts to increase sales of its acquired properties. The letter further stated that the program holds great appeal among consumers because it offers home ownership opportunities to qualified families who would not otherwise be able to purchase and complete needed repairs without the resources made available through this program.

We reviewed 114 case files for properties that the SAAO sold during 1995, and found that it sold 10 properties with FHA insurance but did not complete repairs recommended by the appraiser to meet Minimum Property Standards (MPS). Further, it did not offer HUD's repair escrow program to the buyers to bring the properties up to MPS. SAAO officials explained that its Realty Specialists determined that the repairs were not necessary for the properties to meet MPS and were only cosmetic in nature. We disagree with that interpretation. The initial appraisals included recommended repairs such as: repairing roofs, replacing missing plumbing and toilet fixtures, replacing electrical switches and heating units. These types of repairs, in our opinion, do not appear cosmetic but pertained to deficiencies affecting MPS.

SAAO officials explained that they generally did not need to make the repairs because the properties sold without making the repairs. That statement is also not supported because as explained above, only about half of the properties listed in 1995 received an offer. In addition, HUD's policy is to initially identify any repairs needed to make the properties eligible for FHA insurance. This is accomplished by having individuals, such as appraisers, determine what damages should relate to MPS or cosmetic repairs. We believe that rather than accelerating the sales, the unrepaired condition of the properties may actually discourage potential home buyers, therefore, affecting the turnaround time for selling the properties.

Our interviews with 15 homeowners also disclosed that some incurred additional debts to make the needed repairs, while others delayed or did not make any repairs. For example, three of the homeowners charged the cost of the repairs on their credit cards and another obtained a HUD Title I Home Improvement Loan. Those repairs were considered necessary to meet MPS, such as roof leaks, faulty electrical circuits, and plumbing problems; which are appropriately eligible under the repair escrow program. In our opinion, the escrow program should be used. The homeowners' increased debt to accomplish necessary repairs only increases the potential for default on the original mortgage.

2. Use of Escrow Agents as Bid Drop-Off Points

The SAAO can better serve its clients by adding more bid drop-off points for brokers to submit their bids on listed properties.

Our discussions with 20 selected brokers disclosed that 17 preferred to have more bid drop-off points because the SAAO jurisdiction covers a wide area with only the SAAO location as the drop off point. In addition, SAAO officials acknowledged that their fax system could not adequately handle all incoming bids. Further, there may not be sufficient lead time for brokers to mail in their bids to meet the submission deadline. The brokers commented that the use of the fax machine was ineffective because they did not know if the SAAO received their bids since there was no mechanism to confirm SAAO's receipt of the bids.

The brokers that we contacted commented that using escrow companies that handle the sales closings would be ideal to use as bid drop-off points because those companies are at different locations that are easily accessible from any point within the SAAO jurisdiction. The brokers also suggested that a log-in sheet could be used as a mechanism to confirm that their bids were received. A SAAO official agreed that using escrow companies would be feasible because there is already a daily courier service between the escrow companies and the SAAO.

RECOMMENDATIONS:

We recommend that you:

1A. Lower the downpayment requirement to a maximum of three percent;

1B. Use the repair escrow program to correct deficiencies affecting MPS in order to qualify properties for FHA-insurance; and

1C. Establish additional bid drop-off points with log-in sheets at escrow companies that handle sales closings.

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Within 60 days, please furnish us a status report on the recommendations stating (1) the corrective action taken, (2) the proposed corrective action and the date to be completed, or (3) why action is not needed. Also please furnish us copies of any correspondence or directives related to this review.

Please call Glenn Warner, Assistant District Inspector General for Audit, at (415)436-8104 if you have any questions.