Issue Date July 2, 2007	
Audit Report Number 2007-FW-1011	

TO: Brian D. Montgomery
Assistant Secretary for Housing—Federal Housing Commissioner, H

John L. Garvin
Acting Deputy Assistant Secretary for Multifamily Housing, HT

FROM: Frank E. Baca
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: Capmark Finance, Inc. Misrepresented Asbury Square Apartments', Tulsa, Oklahoma, Financial and Physical Condition When Underwriting the $9.098 Million Loan

HIGHLIGHTS

What We Audited and Why

At the request of the U. S. Department of Housing and Urban Development (HUD), we audited Capmark Finance, Inc.[1] (Capmark) underwriting and processing of the mortgage loan for Asbury Square Apartments (Asbury), located in Tulsa, Oklahoma. We had previously audited Asbury's owner/management agent.[2]

The audit objective was to determine whether Capmark followed multifamily accelerated processing (MAP)[3] and HUD requirements when underwriting and processing the Asbury loan.

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1 Formerly called GMAC Commercial Mortgage Corporation.

2 Audit report number 2007-FW-1006, Aberdeen Villa Apartments, Formerly Asbury Square Apartments, Tulsa, Oklahoma, FHA #118-35200, Spent Almost $35,000 in Project Funds on Ineligible and Unsupported Costs.

3 MAP is designed to establish national standards for approved lenders to prepare, process, and submit loan applications for Federal Housing Administration multifamily mortgage insurance.

What We Found

Capmark misrepresented Asbury's financial and physical situation to HUD in its underwriting narrative. Further, it did not exercise the required amount of due diligence required to support its recommendation for HUD endorsement. The Asbury mortgage loan, as recommended by Capmark, did not provide enough funds to restore the project to a financially viable condition. While Capmark complied with most MAP requirements when underwriting the loan, its underwriting narrative lacked material financial information and analysis. In addition, Capmark did not perform its property site inspection within MAP requirements. As a result, Asbury defaulted on the loan before final closing, causing HUD a possible loss of more than $5.9 million.

What We Recommend

We recommend that the assistant secretary for housing refer Capmark to the Mortgagee Review Board for appropriate action. Further, we recommend that the acting deputy assistant secretary for multifamily housing establish a MAP Lender Review Board. We recommend the MAP Lender Review Board address and resolve violations by Capmark that could cause losses exceeding $5.9 million to HUD's Federal Housing Administration insurance fund and deficiencies in its quality control plan.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided the draft report to HUD on June 4, 2007, and to Capmark on June 5, 2007. We held an exit conference with HUD and Capmark officials on June 15, 2007. In a June 25, 2007 written response, Capmark generally disagreed with the findings.

Capmark's response and our evaluation of the response are located in Appendix B. Capmark's response included exhibits that are available for review upon request.

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BACKGROUND AND OBJECTIVES

Asbury Square Apartments (Asbury), FHA #118-35200, is a 256-unit garden style apartment complex in Tulsa, Oklahoma. On November 29, 2000, Sheltering Palms - Tulsa I, LLC (Sheltering Palms),[4] purchased Asbury for $6.011 million using one-year renewable revenue bond anticipation notes issued by the Tulsa County Industrial Authority. On September 14, 2004, the Federal Housing Administration insured Asbury's $9.098 million mortgage under Section 221(d)(4) of the National Housing Act. Federal Housing Administration insurance protects lenders against loss from mortgage defaults on projects involving substantial rehabilitation of housing units for moderate-income and displaced families.

According to its response, Capmark Finance, Inc., formerly known as GMAC Commercial Mortgage Corporation, originated and underwrote the transaction. Following its issuance but prior to initial endorsement, HUD's firm commitment was assigned to Capmark Bank, formerly know as GMAC Commercial Mortgage Bank. We have addressed the finding to Capmark Finance, Inc. (Capmark).

Capmark and Sheltering Palms entered into the $9.098 million mortgage agreement secured with Tulsa County Industrial Authority bonds backed by Government National Mortgage Association (GNMA) securities. The mortgage included funds to substantially rehabilitate the Asbury property. The Federal Housing Administration insured the mortgaged funds when paid by Capmark during the construction period.

Capmark used the multifamily accelerated processing (MAP) guidelines to underwrite and process the Asbury mortgage loan. Before 2000, the U.S. Department of Housing and Urban Development's (HUD) individual regions had developed their own "fast-track processing" that gave qualified lenders an opportunity to prepare Federal Housing Administration forms and to do preliminary underwriting for multifamily loan applications. HUD developed MAP in an effort to replace "fast-track" processing in each region so the process was consistent throughout HUD. Under the MAP guidelines, Capmark directed the preparation, reviewed required exhibits including the appraisal, conducted the underwriting, and recommended the Asbury loan for HUD endorsement.

HUD relied upon Capmark to properly underwrite and process the Asbury loan using the MAP guidelines. HUD provides minimum oversight for loans underwritten and processed through MAP. For the Asbury mortgage credit underwriting and processing, the MAP guide generally required HUD officials to review previous participation certifications, Capmark's underwriting narrative, and form HUD-92264-A.[5] The MAP guide required HUD to use those reviews to decide the "maximum insurable mortgage," "total financial requirements" for initial closing; and if the sponsor, the mortgagor, and its

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4 Sheltering Palms Foundation, Inc., a nonprofit corporation, owns Sheltering Palms - Tulsa I, LLC.

5 This is a supplement to the project analysis that reports values used to determine the maximum insurable mortgage and estimated cash requirement for closing.

key principals are acceptable.[6] The MAP guide does not require HUD officials to duplicate lenders' underwriting.

Capmark's underwriter was mainly responsible for recommending that HUD either accept or reject the Asbury loan after it concluded that the borrower was able "to manage the development, construction, completion, and successful lease-up of the property."[7] HUD required Capmark to underwrite the loan to ensure that Asbury would be a viable project following the planned rehabilitation. The MAP guide required Capmark to thoroughly analyze Asbury's credit worthiness and financial condition to help it determine whether Asbury would have enough income to cover its total obligations.[8] Following its analysis, Capmark certified that the Asbury loan was an acceptable risk to the Federal Housing Administration's mortgage insurance fund and recommended that HUD insure the loan.

The audit objective was to determine whether Capmark followed MAP and HUD requirements when underwriting and processing the Asbury loan.

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6 MAP guide, chapter 8.17.

7 MAP guide, chapter 8.3 A.

8 MAP guide, chapter 8.1 B.

RESULTS OF AUDIT

Finding: Capmark Misrepresented Asbury's Financial and Physical Condition When Underwriting Its $9.098 Million Loan

Capmark misrepresented Asbury's financial and physical situation to HUD in its underwriting narrative. Further, it did not exercise the required amount of due diligence required to support its recommendation for HUD endorsement. Specifically, Capmark did not inform HUD of vital financial information and did not perform a thorough financial analysis. Moreover, it did not completely identify property rehabilitation needed by Asbury to be viable. These deficiencies existed because Capmark did not practice due diligence when underwriting the loan.[9] Consequently, Capmark's report to HUD significantly understated the risk of the Asbury loan insured by the Federal Housing Administration. As a result, the project did not have funds to maintain itself, and the owners defaulted on the mortgage note. The possible loss to HUD could be more than $5.9 million.

Capmark Did Not Inform HUD of Vital Financial Information and Did Not Perform a Thorough Financial Analysis

Capmark failed to provide sufficient due diligence when it did not discuss the negative working capital balance in its report to HUD, did not obtain and review the aged accounts payable, and did not evaluate the current and future financial capacity of the project. Because Capmark did not include and analyze material financial information, it significantly understated the risk to HUD when it recommended the loan for endorsement in its underwriting narrative.

In its narrative, Capmark did not discuss Asbury's negative working capital balance as required. The mortgage credit analysis worksheet for the owner of Asbury showed that Asbury had a $1.1 million negative working capital balance,[10] indicating that it had significantly more debts than resources to pay for them. HUD's MAP guide required Capmark to prepare a report to HUD recommending that HUD either accept or reject the loan. The report "must detail the project's financial requirements" and "must address positive and negative findings known by" Capmark about

[9] For ease, we have included a timeline of documents as Appendix C.
[10] $52,383 current assets minus $1,157,265 current liabilities.

Asbury's financial condition.[11] Although Capmark attached the mortgage credit analysis worksheet to the underwriting narrative, it did not address the owner's negative working capital in the narrative as required. While the new mortgage would pay off $736,526 in mortgage obligations, it would not cover the remaining $420,738 liabilities, consisting of $241,193 accounts payable for goods and services, $161,497 owner loans,[12] $17,098 tenant security deposits,[13] and $950 prepaid rents. With a cash balance of only $14,931 to cover these debts, it should have been clear that the project would have a difficult time just making it to final closing.

Capmark violated MAP requirements when it did not obtain an aged accounts payable schedule. HUD required Asbury's aged accounts payable schedule, among others, so Capmark could determine Asbury's financial capacity.[14] The accounts payable aging schedule gave an indication of the amount of cash needed to cover the project's expenses. Asbury's aged accounts payable schedule disclosed that 73 percent[15] of the accounts were 90 or more days overdue. Since Capmark did not obtain the accounts payable schedule, it was unable to completely assess the financial responsibility and capacity of the owner. This lack of due diligence prevented Capmark from reporting that the owner was not able to pay debts in a timely manner. Capmark could not justify the reasons for the untimely payments. Further, it did not explain how Asbury would pay off existing overdue debts and prevent further future indebtedness.

Capmark did not fully evaluate Asbury's current and future financial capacity. The MAP guide required Capmark to project future costs and calculate an initial operating deficit.[16] HUD designed the initial operating deficit account to financially stabilize a borrower during substantial rehabilitation. Asbury could only use the account for expenses incurred after initial closing.[17] Therefore, Asbury could not use initial operating deficit funds to pay the already existing $241,193 payables and any additional expenses that occurred between January 1 and September 13, 2004. Capmark's narrative did not demonstrate how Asbury could pay its existing debts when its occupancy indicated that it would not have sufficient funds to pay current expenses. At the time of the first underwriting narrative,[18] Asbury's occupancy was 41.73 percent. Capmark estimated that the project would need at least 86 percent occupancy to cover the current expenses of the property. Capmark's

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11 MAP guide, chapter 8.16 E.
12 Under the regulatory agreement, Asbury could not repay the owner loans unless it had surplus cash.
13 Capmark informed us that there were restricted assets to cover this liability.
14 MAP guide, chapter 8.4 B.
15 We used the December 2003 aged accounts payable schedule, which had a different total than shown in the financial statements used by Capmark for its credit analysis.
16 MAP guide, chapter 7.14 A.
17 Asbury's loan initially closed on September 14, 2004.
18 March 29, 2004.

mortgage credit analysis worksheet showed that Asbury had available cash of only $14,931 to pay towards its current accounts payable of $241,193. With Asbury's financial situation, Capmark needed to ensure that Asbury had funds to sustain the project during and immediately after substantial rehabilitation. Asbury did not have sufficient funds to pay its debts in a timely manner and had significant outstanding debts that Capmark should have included in its analysis of Asbury's cash requirements.

Capmark was responsible for preparing a narrative to support its recommendation to accept or reject the loan, requiring it to ensure Asbury had funds to sustain the project throughout construction. Capmark failed to provide sufficient information and analysis when it did not include a discussion of the negative working capital balance in the narrative, did not obtain and review the aged accounts payable, and did not evaluate the current and future cash flows of the project up through the projected final closing.

Capmark Did Not Completely Identify Property Rehabilitation Needed by Asbury to Be Viable

Contrary to HUD requirements, Capmark's architect did not participate in a thorough site inspection after HUD issued its MAP invitation letter on September 22, 2003. The MAP guide required a thorough joint inspection to follow HUD's MAP invitation letter[19] to determine the type and extent of work that would make Asbury viable.

The MAP guide required another site inspection if the joint inspection was performed several months in advance of the firm application. The purpose of the requirement was to "provide any necessary additional conditions for Firm Commitment."[20] Capmark did not schedule another inspection, even though the documented inspection took place several months in advance of the firm application. Capmark's files contained a report of a site inspection performed on January 31, 2003, more than seven months before HUD issued the invitation letter indicating preapplication approval and more than 14 months before HUD received the firm application.[21] Because the inspection was performed earlier than HUD's preapplication approval and Capmark did not require an additional site inspection, the owner's architectural drawings and specifications did not address all of the property's rehabilitation needs. Instead, the architect prepared drawings and specifications that generally matched the May 12, 2003 basic work

[19] HUD's invitation or preapplication approval for the lender to submit a firm application.
[20] MAP guide, chapter 5.14.
[21] HUD received the firm application on March 30, 2004.

write-up[22] and did not include additional needed repairs identified by the contractor and the owner's architect while they were on site.

The MAP guide required an additional site inspection "if property damage may have occurred…" to determine the "current physical condition" of the property.[23] Capmark officials took no action to perform a site inspection after they received information that property damage might have occurred. As early as October 8, 2003, more than five months before Capmark sent the firm application to HUD, both the former contractor and the owner's architect explained to Capmark that the work scope did not include many of the vital repairs needed by the project. The contractor wrote that there were uninhabitable units, which were not in the contractor's estimate, that the hot water piping had significant problems, and that some units had water heaters that did not work. The contractor explained that the project was located in a high theft area and that some units had been cannibalized.

On December 12, 2003, more than three months before Capmark submitted the firm application, it received a rent roll from Asbury showing that the project had 78 unrentable units as of October 31, 2003, 33 more than the 45 units included in the May 12, 2003 work scope. In November 2003, four months before Capmark submitted the firm application, the project had 87 uninhabitable units[24] that were not included in the rehabilitation plan. Since Capmark did not schedule a site inspection after it received the property information, it did not include the necessary rehabilitation to make Asbury decent, safe, and marketable as required by the MAP guide.[25]

Sheltering Palms officials planned to use project funds to repair the uninhabitable units that were not in the work scope. However, the project could not afford the costs. Based on the current financial data that Capmark used to underwrite the loan, as discussed earlier, it was clear that Capmark should have known that Sheltering Palms could not repair the units with project funds and should have disclosed this to HUD. Asbury already had more than $241,000 in debts that it could not pay from the initial operating deficit account. Further, it did not have the occupancy necessary to pay current expenses.

Because Capmark failed to conduct another site inspection, it reported incomplete and inaccurate property information to HUD in its underwriting narrative. In the narrative, Capmark did not report that the project had significant hot water piping problems and had missing or inoperable water heaters. The narrative incorrectly reported that the

22 The basic work write-up reported 45 units that needed rehabilitation.
23 MAP guide, chapter 5.14.
24 Thirty-four percent of the total number of units.
25 MAP guide, chapter 5.16.

planned rehabilitation would enable the project to "achieve and maintain" at least 92 percent occupancy. The planned rehabilitation only included 43[26] of the 130 units that needed repairs to become habitable. Since the work scope did not include repairs for 87 uninhabitable units, it ensured that only 66 percent of the units would be rentable following the construction.[27] The 66 percent maximum occupancy is significantly less than the 86 percent minimum occupancy that Asbury needed to pay project expenses and debt service requirements.

HUD Recognized a Loss After Asbury Defaulted on the Loan

HUD has already recognized a loss of more than $5.249 million. This amount could increase to more than $5.9 million. Asbury defaulted on its mortgage on September 1, 2005, before reaching final endorsement.[28] On March 1, 2006, Capmark assigned the mortgage note to HUD. By February 28, 2007, HUD had paid more than $8.745 million to settle Capmark's claim, sold the note for more than $3.378 million, and received $117,430 in interest income from the GNMA bonds that financed the loan, a loss of more than $5.249 million.

Capmark did not pay the general contractor $684,698 after it certified that it completed the rehabilitation and after HUD had completed the cost certification. As a result, the general contractor put a lien on the property and is working to recover the $684,698 from HUD. Capmark should reimburse HUD for any amounts paid on the general contractors claim. This will protect the FHA fund from a potential $684,698 additional loss on this loan.

Conclusion

Capmark did not practice due diligence when underwriting the Asbury loan. Further, it lacked sufficient policies and procedures to comply with HUD requirements. It did not inform HUD of vital financial information, did not document that it had thoroughly analyzed Asbury's financial condition, and did not identify needed property rehabilitation. As a result, it recommended a loan that defaulted before final closing, causing HUD a

26 Under the work scope, 43 down units would be rehabilitated with one unit being converted to two and a clubhouse converted into a living unit. After the rehabilitation, 45 units would be completed.
27 As of June 27, 2006, no tenants had lived in 84 of the 87 units since October 2003. The units needed repairs costing more than $280,000.
28 HUD had not conducted the final closing of the mortgage insurance transaction, which occurs after completion of construction, although HUD had approved the cost certification.

loss of more than $5.249 million, and could cause an additional loss of $684,698 if not reimbursed by Capmark.

Recommendations

We recommend that the assistant secretary for housing

1A. Refer Capmark to the Mortgage Review Board for appropriate remedial actions.

We recommend that the acting deputy assistant secretary for multifamily housing

1B. Establish a MAP lender review board to review the violations by Capmark.

We recommend that the MAP lender review board address and resolve with Capmark

1C. Violations that caused a $5,249,414 loss to HUD’s FHA insurance fund.

1D. Violations that could cause an additional $684,698 loss to HUD’s FHA insurance fund.

1E. Implementation and revisions necessary to Capmark’s quality control plan to ensure that its staff reviews and submits to HUD, with the firm application, the required supporting schedules with the borrower’s financial statements.

1F. Implementation and revisions necessary to its quality control plan to ensure that it schedules a MAP-required joint inspection after HUD issues its preapplication approval.

1G. Implementation and revisions necessary to its quality control plan to ensure that it schedules a site inspection if either property damage may have occurred or an abnormal amount of time has elapsed between the joint inspection and the firm application.

SCOPE AND METHODOLOGY

We conducted the audit at Capmark's office located in St. Louis, Missouri, and HUD's Oklahoma City, Oklahoma, Office of Multifamily Housing. The audit period was from January 1, 2003, through May 31, 2006. We conducted the audit from December 13, 2006, through March 23, 2007. During the audit, we performed the following steps:

- Reviewed background information and the criteria that controlled Capmark's underwriting and processing of the Asbury loan.
- Reviewed Capmark's quality control plan, policies, and procedures.
- Conducted interviews with HUD officials,[29] the lender, the appraiser, the architects, the contractor, and the borrower.
- Reviewed documents in Asbury's loan files located in Capmark's St. Louis office.
- Reviewed selected Asbury rent rolls.

We performed the audit in accordance with generally accepted government auditing standards.

[29] Some of the officials involved with Asbury have retired.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined the following internal control was relevant to our audit objectives:

- Policies and procedures that Capmark implemented to reasonably ensure that it underwrote and processed the Asbury loan in conformity with MAP requirements.

We assessed the relevant controls identified above. A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Significant Weaknesses

Based on our review, we believe the following items are significant weaknesses:

- Capmark did not have policies and procedures to ensure that its staff reviewed and submitted to HUD, with the firm application, schedules with the mortgagor's financial statements, including an accounts payable schedule with aging information, as required by the MAP guide.

- Capmark did not have policies and procedures for scheduling site inspections as required by the MAP guide.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS BE PUT TO BETTER USE

Recommendation Number	Ineligible 1/	Funds be put to better use 2/
1C	$5,249,414	
1D		$684,698
Totals	$5,249,414	$684,698

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state, or local policies or regulations.

2/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (OIG) recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified. In this instance, implementation of our recommendation to have Capmark indemnify HUD from future loss on the Asbury loan will reduce the Federal Housing Administration's risk of loss to the insurance fund.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

June 25, 2007

CAPMARK

Mr. Frank E. Baca
Regional Inspector General
U.S. Department of Housing and Urban Development
Region VI, Office of Inspector General
819 Taylor Street, room 13A09
Fort Worth, TX 76102

RE: Response to Draft OIG Audit
Asbury Square Apartments
Tulsa, Oklahoma
FHA Project No. 118-35200
Audit Report No. 2007-FW-100X

Dear Mr. Baca:

We appreciate the opportunity to review and respond to OIG's draft audit findings relative to the above-referenced transaction, and we appreciate the time and effort that OIG staff have spent reviewing this matter.

Comment 1

However, we do not agree with OIG's conclusions generally, and more particularly, we categorically deny the assertion in the draft audit report that we misrepresented the financial and physical circumstances of the Asbury Square Apartments project to HUD, and also the assertion that we did not perform a property site inspection within MAP requirements.

Comment 2

First and foremost, we need to point out that the draft report indicates that the subject of OIG's audit was *"Capmark Finance Bank"*, with a footnote indicating that Capmark Finance Bank was *"Formerly called GMAC Commercial Mortgage Bank"*. A clarification of the parties involved and their respective roles appears warranted under the circumstances. The subject transaction was originated and underwritten by Capmark Finance Inc. (Capmark), formerly known as GMAC Commercial Mortgage Corporation. Following its issuance, but prior to initial endorsement, HUD's Firm Commitment was assigned to Capmark Bank, formerly known as GMAC Commercial Mortgage Bank, who in turn closed the loan in its name. Capmark was what some in the industry would refer to as the "processing mortgagee", while Capmark Bank was the "mortgagee of record" or "servicing mortgagee". While its anticipated that OIG will take steps to correct its report, both Capmark and Capmark Bank participated in the preparation of this response.

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Lest it be forgotten, we want to underscore Capmark's long standing commitment to HUD. Capmark has been one of the largest originators and servicers of HUD multifamily loans for many years. Our current FHA insured portfolio stands at $9+ billion and since inception of the MAP program we have closed approximately $2 billion of MAP processed transactions. We place a very high value on our relationship with HUD and make every attempt to act in full compliance with HUD's rules and regulations.

By way of background, the subject transaction fell into monetary default in September, 2005, and was subsequently assigned to HUD on March 1, 2006. Prior to its assignment, Capmark received notice from [redacted] Acting Director, Lender Qualifications and Monitoring Division, that HUD would be performing a Quality Assurance review of the transaction. During the course of said review, the LQMD team leader made a request for Capmark to complete a loan default analysis of the transaction. Capmark issued its Mortgage Default Review to HUD on March 31, 2006 [Exhibit A]. It should be noted that Capmark's Mortgage Default Review included a Notice to LQMD of suspected violations, as required by Appendix III REV-3, Section IV.M. of the MAP Guide. Indeed, following its review Capmark believed there to be sufficient evidence to support a more detailed review or audit of Asbury Square's operations given concerns of possible violations of law, regulation, false statements, or program abuses carried out by the mortgagor or the management agent. Presumably in response to Capmark's Notice, OIG conducted a survey of the transaction, the results of which were apparently sufficient to warrant a request from HUD for OIG to conduct an audit of Asbury Square Apartments (owner and manager) and Capmark.

OIG RESULTS OF AUDIT

OIG Finding: Capmark Finance Bank Misrepresented Asbury's Financial and Physical Condition When Underwriting Its $9.098 Million Loan

Capmark misrepresented Asbury's financial and physical situation to HUD in its underwriting narrative. Further, it did not exercise the required amount of due diligence required to support its recommendation for HUD endorsement. Specifically, Capmark did not inform HUD of vital financial information and did not perform a thorough financial analysis. Moreover, it did not completely identify property rehabilitation needed by Asbury to be viable. These deficiencies existed because Capmark did not practice due diligence when underwriting the loan. Consequently, Capmark's report to HUD significantly understated the risk of the Asbury loan insured by the Federal Housing Administration. As a result, the project did not have funds to maintain itself, and the owners defaulted on the mortgage note. The possible loss to HUD could be more than $5.9 million.

OIG Finding: Capmark Did Not Inform HUD of Vital Financial Information and Did Not Perform a Thorough Financial Analysis

Capmark failed to provide sufficient due diligence when it did not discuss the negative working capital balance in its report to HUD, did not obtain and review the aged accounts payable, and did not evaluate the current and future financial capacity of the project. Because Capmark did not include and analyze material financial information, it significantly understated the risk to HUD when it recommended the loan for endorsement in its underwriting narrative.

In its narrative, Capmark did not discuss Asbury's negative working capital balance as required. The mortgage credit analysis worksheet for the owner of Asbury showed that Asbury had a $1.1 million negative working capital balance, indicating that it had significantly more debts than resources to pay for them. HUD's MAP guide required Capmark to prepare a report to HUD recommending that HUD either accept or reject the loan. The report "must detail the project's financial requirements" and "must address positive and negative findings known by" Capmark about Asbury's financial condition. Although Capmark attached the mortgage credit analysis worksheet to the underwriting narrative, it did not address the owner's negative working capital in the narrative as required. While the new mortgage would payoff off $736,526 in mortgage obligations, it would not cover the remaining $420,738 liabilities, consisting of $241,193 accounts payable for goods and services, $161,497 owner loans, $17,098 tenant security deposits and $950 prepaid rents. With a cash balance of only $14,931 to cover these debts, it should have been clear that the project would have a difficult time just making it to final closing.

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the reasons for the untimely payments. Further it did not explain how Asbury would pay off existing overdue debts and prevent further future indebtedness.

Capmark did not fully evaluate Asbury's current and future financial capacity. The MAP guide required Capmark to project future costs and calculate an initial operating deficit. HUD designed the initial operating deficit account to financially stabilize a borrower during substantial rehabilitation. Asbury could only use the account for expenses incurred after initial closing. Therefore, Asbury could not use initial operating deficit funds to pay the already existing $241,193 payables and any additional expenses that occurred between January 1 and September 13, 2004. Capmark's narrative did not demonstrate how Asbury could pay its existing debts when its occupancy indicated that it would not have sufficient funds to pay current expenses. At the time of the first underwriting narrative, Asbury's occupancy was 41.73 percent. Capmark estimated that the project would need at least 86 percent occupancy to cover the current expenses of the property. Capmark's mortgage credit analysis worksheet showed that Asbury had available cash of only $14,931 to pay towards its current accounts payable of $241,193. With Asbury's financial situation, Capmark needed to ensure that Asbury had funds to sustain the project during and immediately after substantial rehabilitation. Asbury did not have sufficient funds to pay its debts in a timely manner and had significant outstanding debts that Capmark should have included in its analysis of Asbury's cash requirements.

Capmark was responsible for preparing a narrative to support its recommendation to accept or reject the loan, requiring it to ensure Asbury had funds to sustain the project throughout construction. Capmark failed to provide sufficient information and analysis when it did not include a discussion of the negative working capital balance in the narrative, did not obtain and review the aged accounts payable and did not evaluate the current and future cash flows of the project up through the projected final closing.

I. Capmark's Response

Comment 3

A. Capmark disagrees with OIG's finding that it did not discuss the negative working capital balance in our report to HUD. Section 8.16 of the MAP Guide states, *"The lender's underwriter's recommendation after review of all processing is made in a report addressed to HUD. The report must detail the project's financial requirements and the credit capacity of the sponsors and the general contractor"*. The MAP guide does not specifically require that this report be contained within the underwriting narrative.

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Section VIII.B. of Capmark's underwriting narrative delivered to HUD in its firm application states: *"The complete Mortgage Credit Analysis Worksheet is attached to this underwriting narrative and provides evaluation of the financial capability and credit worthiness of the mortgagor entity, sponsor and the general contractor"*. {emphasis added}

Comment 3

Capmark's Mortgage Credit Analysis Worksheet discussed the mortgagor's current and historical financial status, stating: *"The financial activity in 2001, 2002 and 2003 reflect a negative net worth and working capital due to reduced occupancy of the project because of the problems with HVAC systems described in the underwriting. The mortgagor has been supported though this period by its sponsor, Sheltering Palms"*.

Comment 1

Capmark's letter of March 29, 2004 used to transmit the firm application package to HUD noted that: *"2003 Financials for Sheltering Palms Foundations, Inc. – the sole member of the mortgagor (Shelter Palms – Tulsa I, LLC) does not have audited Financial Statements for 2003. It is anticipated that these statements will not be completed until September, 2004. The mortgagor has stated that no material adverse changes have occurred over the past year. Although, the Financial Statements that have been provided for Sheltering Palms Foundation, Inc. are showing a net loss, this is caused by depreciation and amortization"*.

Comment 3

Undeniably, HUD was well aware of the mortgagor's negative working capital situation, acknowledging same in a letter dated May 27, 2004, from Mr. J. Tom Miller, Director, Multifamily Program Center, Oklahoma City HUD Field Office, to Mr. Henry P. Coors, Vice President of Capmark, requesting current financial statements for the sponsor, Sheltering Palms Foundation. The letter stated: *"The financial statements that were provided on both the mortgagor and sponsor reflect a negative working capital and net worth position. A current (2003) financial statement is needed to accurately access/document the financial position of the sponsor"*. A 2003 financial statement for the sponsor was received by Capmark on June 17, 2004, and was forwarded that same day to Mr. Dan Doyle, Team Leader, Oklahoma City HUD Field Office, for review.

B. Regarding the $161,497 of "owner loans", Capmark's firm application package to HUD included a letter from the sponsor, Sheltering Palms Foundation, Inc. dated March 24, 2004, confirming that the $161,497 of unsecured debt owed by the mortgagor would be extinguished by the date of closing of the HUD loan,

Capmark relied upon the sponsor's commitment to extinguish the debt in their financial analysis, however, the debt along with several other discrepancies were

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discovered by Capmark in the mortgagor's financial reporting following initial endorsement.

1. On July 22, 2005, the mortgagor provided Capmark with audited financial statements for the year ending 12/31/04 which reflected "Loans from Sheltering Palms Foundation, Inc." under Current Liabilities totaling: $161,497 as of 12/31/02, $267,636 as of 12/31/03, and $416,525 as of 12/31/04.

Comment 4

2. The amount of $267,636 as of 12/31/03 does not agree with the information contained in the mortgagor's certified, un-audited financial statements for the year ending 12/31/03 (relied upon by Capmark in underwriting its firm application for mortgage insurance), which reflected "Loans from Sheltering Palms Foundation, Inc." under Current Liabilities totaling: $161,497 as of 12/31/02 <u>and</u> 12/31/03. The mortgagor's audited financial statements for 2004 reflects an increase in "Loans from Sheltering Palms Foundation, Inc." as of 12/31/03 of some $106,139 over the amount reflected in the mortgagor's certified financial statements dated 12/31/03.

3. The information contained in the mortgagor's audited financial statements for the year ending 12/31/04 also stands in stark contrast to the sponsor's letter dated March 24, 2004, confirming that *"the unsecured debt owed by Sheltering Palms – Tulsa I, LLC (the "Mortgagor") to Sheltering Palms Foundation, Inc. in the amount of $161,497 that is reflected on the Mortgagor's financial statements will be extinguished by the date of closing of the HUD loan"*.

4. Moreover, according to the information contained in the mortgagor's audited financial statements for the year ending 12/31/04, Sheltering Palms Foundation, Inc. lent the mortgagor additional sums totaling $148,889. The mortgagor did not communicate to Capmark that additional encumbrances were placed against the subject property and Capmark has no record of HUD authorizing the mortgagor to incur these additional obligations.

Comment 5

C. The $17,098 in tenant security deposits referenced above was included in the underwriter's analysis of the mortgagor's 2003 financial statement as a current liability, while the security deposits held in trust by the mortgagor were included in "restricted funds" of $22,086 reflected as a non-current asset. This made it appear as if there were no funds available to offset the security deposit liability, when in fact funds were available.

D. Capmark did obtain an aged payables schedule from the Mortgagor in accordance with MAP Guide requirements **[Exhibit B]**. Capmark retained an electronic copy

Comment 6

Comment 7

Comment 6

of said aged payable schedule which had become corrupted. As a result we have been unable to produce a copy of this document until we were able to restore the files formatting. The information contained in the aged payables schedule obtained by Capmark and referenced in its firm application only lent further support to the sponsor's report that it had been financially supporting the project since its decline in operations due to the failure of its HVAC systems.

1. Capmark's firm application included an analysis of the mortgagor's financial statements for 2001, 2002 and 2003 within the Mortgage Credit Analysis Worksheet. The mortgagor's certified financial statements reflected Accounts Payable under Current Liabilities of $217,976.29 as of 12/31/02 and $241,193.43 as of 12/31/03, reflecting a nominal 10.65% variance given the known decline in operations.

2. Included in Capmark's firm application was a letter signed by [redacted] President of Sheltering Palms Foundation, Inc., dated February 24, 2004, confirming that the accounts payable had "decreased" to $175,169.78 as of February 27, 2004 – a 27% decline from the $241,193.43 reflected in the mortgagor's certified financial statements as of 12/31/03.

   The letter also confirmed for Capmark and HUD that *"the Foundation acknowledges the responsibilities and obligations of sponsorship of this project and is committed to continued ownership and successful operation of the project including rehabilitation and return to occupancy above 90%"*. The subject letter was specifically referenced in a discussion of the proposed mortgagor's current and historical financial status within Capmark's Mortgage Credit Analysis Worksheet and identified as being *"part of the underwriting of this project"*.

3. Included in Capmark's firm application was a credit report on the mortgagor dated March 8, 2004 which contained no derogatory information.

4. Following initial endorsement the mortgagor provided an Aged Payables Schedule dated 09-30-04 in connection with its first request for release of monies from the operating deficit escrow, which reflected an additional 13% decline since 02-27-04 in total accounts payable to $151,696.10.

5. Capmark notes with some interest that the aged payables schedule only recently provided to OIG by the mortgagor reflects total accounts payable as of 12/31/03 of $157,126.13. While an explanation as to how the mortgagor reconciles the $157,126.13 to the $241,193.43 reflected in the certified financial statements delivered to Capmark would be intriguing to say the least, Capmark is even more curious to understand OIG's apparent decision to rely upon the $241,193.43 (as opposed to the $157,126.13) in drawing its conclusions under its draft audit report

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Capmark fulfilled the requirements of Section 8.16 of the MAP Guide, detailing the project's financial requirements and discussing the positive and negative findings known by the lender, based on the information available. Throughout both the pre-application and firm submissions it was repeatedly disclosed to HUD that the subject had suffering a significant decrease in occupancy due to the failure of the boiler/chillers systems, as well as a sewer line back-up that affected some units. A historical occupancy breakdown was included in both the pre-application and firm application submissions demonstrating the subject's stabilized occupancy prior to these problems and the decline in occupancy after the failure of the boiler/chillers/sewer line.

Comment 8

E. Capmark disagrees with OIG's findings that Capmark failed to evaluate the current and future cash flows of the project up through the projected final closing. A thorough discussion of the appraiser's and underwriter's operating deficit calculations can be found in Section V.C.15. of the narrative. The Appraiser determined that there was no need for an operating deficit, while Capmark's underwriter, relying upon more conservative estimates, concluded that an operating deficit escrow of $150,429 should be required. Capmark's firm application package to HUD included an operating deficit worksheet detailing the calculations behind the underwriter's recommendation.

Comment 9

F. The statement that Asbury could only use the Initial Operating Deficit account for expenses incurred after the initial closing is correct in theory, however; the mortgagor/management agent submitted and HUD approved requests for reimbursement of operating expenses incurred prior to initial endorsement from the operating deficit. This resulted in the premature depletion of the operating deficit escrow with no other source of funds available to meet deficits until the project achieved breakeven operations.

Comment 10

Additionally, a careful examination of the requests for reimbursement from the operating deficit escrow by Capmark during its default analysis review revealed incidences where the mortgagor did not disclose income they had received, resulting in duplicate reimbursements. As a result, the mortgagor received overpayments from the operating deficit escrow of approximately $42,592.

1. Example #1

   At the time of initial closing it was expected that $24,364 of excess funds held by the Trustee in connection with the prior bonds would be transferred to Capmark for deposit into an escrow to cover future property insurance premiums. However, despite Capmark's instructions and the Trustee's acknowledgement of same, following initial endorsement counsel for the mortgagor interceded in the matter arguing that the monies were due the mortgagor based upon the prior trust indenture. At the sponsor's direction, the Trustee remitted $12,000 to the City of Tulsa Water Department for application against delinquent sums due and the balance of $12,364.06 was wired to what was reported to be an account of the mortgagor.

By letter dated October 7, 2004, the mortgagor requested a release of $21,296 from the operating deficit escrow for the month of September, 04'. The operating deficit reserve worksheet submitted in support of said request reflected total cash received of $4,722 and total cash disbursements of $27,949.01. The reported cash receipts did not include the $24,364.06 received (or credited on the mortgagor's behalf) during the month of September. Moreover, the cash disbursements did include the $12,000 paid by the Trustee to the City of Tulsa Water Department. Had the $24,364.06 been properly reflected in the mortgagor's cash receipts, the worksheet would have concluded that the property had positive cash flow of $1,137.05 during the month of September, 04'. Instead, HUD approved the mortgagor's request and authorized the release of $21,296 from the operating deficit escrow.

2. Example #2

   By letter dated November 9, 2004, the mortgagor requested a release of $32,554.32 from the operating deficit escrow for the month of October, 04'. However, the amount requested was based upon the prior months ending balance without reflection of the release of monies from the operating deficit escrow of $21,296. The combination of carrying forward the prior month's general ledger negative balance without properly accounting for the prior release of funds from the operating deficit resulted in the mortgagor receiving duplicate reimbursement of the $21,296 when HUD approved the mortgagor's request and authorized the release of $32,544.32 from the operating deficit escrow.

3. Example #3

   By letter dated December 8, 2004, the mortgagor requested a release of $29,201.50 from the operating deficit escrow for the month of November, 04'. The mortgagor's supporting documentation reflects a loan payment to Sheltering Palms Foundation, Inc. (the sponsor) in the amount of $8,018.03 occurring on November 3, 2004. The payment was in violation of the regulatory agreement given that the project was not generating surplus cash at the time of the payment. Moreover, including the payment in its request for release of monies from the operating deficit escrow was a violation of

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the operating deficit escrow agreement as the loan payment was not an operating expense. HUD approved the mortgagor's request and authorized the release of $29,201.50 from the operating deficit escrow.

OIG Finding: Capmark Did Not Completely Identify Property Rehabilitation Needed by Asbury to be Viable

Contrary to HUD requirements, Capmark's architect did not participate in a thorough site inspection, which occurred more than seven months before HUD issued its MAP invitation letter on September 22, 2003. The MAP guide required a thorough joint inspection to follow HUD's MAP invitation letter to determine the type and extent of work that would make Asbury viable.

The MAP guide required another site inspection if the joint inspection was performed several months in advance of the firm application. The purpose of the requirements was to "provide any necessary additional conditions for Firm Commitment." Capmark did not schedule another inspection, even though the documented inspection took place several months in advance of the firm application. Capmark's files contained a report of a site inspection performed on January 31, 2003, more than seven months before HUD issued the invitation letter indicating pre-application approval and more than 14 months before HUD received the firm application. Because the inspection was performed earlier than HUD's pre-application approval and Capmark did not require an additional site inspection, the owner's architectural drawings and specifications did not address all of the property's rehabilitation needs. Instead, the architect prepared drawings and specifications that generally matched the May 12, 2003 basic work write-up and did not include additional needed repairs identified by the contractor and the owner's architect while they were on site.

The MAP guide required an additional site inspection "if property damage may have occurred..." to determine the "current physical condition" of the property. Capmark officials took no action to perform a site inspection after they received information that property damage might have occurred. As early as October 8, 2003, more than five months before Capmark sent the firm application to HUD, both the former contractor and the owner's architect explained to Capmark that the work scope did not include many of the vital repairs needed by the project. The contractor wrote that there were uninhabitable units, which were not in the contractor's estimate, that the hot water piping had significant problems and that some units had water heaters that did not work. The contractor explained that

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the project was located in a high theft area and that some units had been cannibalized.

On December 12, 2003, more than three months before Capmark submitted the firm application; it received a rent roll from Asbury showing that the project had 78 unrentable units as of October 31, 2003, 33 more than the 45 units included in the May 12, 2003 work scope. In November 2003, four months before Capmark submitted the firm application, the project had 87 uninhabitable units that were not included in the rehabilitation plan. Since Capmark did not schedule a site inspection after it received the property information, if did not include the necessary rehabilitation to make Asbury decent, safe and marketable a required by the MAP guide.

Sheltering Palms officials planned to use project funds to repair the uninhabitable units that were not in the work scope. However, the project could not afford the costs. Based on the current financial data that Capmark used to underwrite the loan, as discussed earlier, it was clear that Capmark should have know that Sheltering Palms could not repair the units with the project funds and should have disclosed this to HUD. Asbury already had more than $241,000 in debts that it could not pay from the initial operating deficit account. Further it did not have the occupancy necessary to pay current expenses.

Because Capmark failed to conduct another site inspection, it reported incomplete and inaccurate property information to HUD in its underwriting narrative. In the narrative, Capmark did not report that the project had significant hot water piping problems and had twelve missing or inoperable water heaters. The narrative incorrectly reported that the planned rehabilitation would enable the project to "achieve and maintain" at least 92 percent occupancy. The planned rehabilitation only included 43 of the 130 units that needed repair to become habitable. Since the work scope did not include repairs for 87 uninhabitable units, it ensured that only 66 percent of the units would be rentable following the construction. The 66 percent maximum occupancy is significantly less than the 86 percent minimum occupancy that Asbury needed to pay project expenses and debt service requirements.

II. Capmark's Response

A. Capmark acknowledges that its joint inspection occurred prior to HUD's pre-application approval and that this is inconsistent with the MAP Guide requirement, but disagrees that the variance had any affect on the sufficiency of the scope of work.

Comment 11

Comment 12

The MAP Guide, Section 5.16 provides: *"As soon as possible after the pre-application approval is issued by HUD, the lender should schedule an on-site inspection with the mortgagor."* {emphasis added} [redacted], the architectural and cost analyst engaged by Capmark, visited the property on three separate occasions meeting with various individuals.

1. On 01/31/03, he met with Capmark's representative [redacted] the mortgagor and the management agent. This was not the joint inspection required by HUD under Section 5.16 of the MAP Guide.
2. On 05/7/03, he met with [redacted] of Real Estate Management Consultant, who was hired by the mortgagor to develop a basic outline of work for the subject property. Nor was this the joint inspection required by HUD under Section 5.16 of the MAP Guide.
3. On 08/07/03, he met with the mortgagor's architects, as well as [redacted] (HUD Project Manager) and [redacted] (HUD Appraiser). During that meeting all parties agreed to the basic scope of rehabilitation work that needed to be done. This was the joint inspection required in Section 5.16 of the MAP guide.

Included in OIG's draft report under Appendix C was a timeline detailing certain events associated with the subject transaction, including all three of the inspections referenced above. However, the basis upon which the OIG determined that the earliest (first) inspection completed by Capmark's architectural and cost analyst on January 31, 2003 was in fact the joint inspection required under the MAP Guide remains unknown. Clearly HUD's participation in the joint site inspection that occurred on August 7, 2003, demonstrates HUD's acceptance of the joint inspection prior to issuing its invitation letter on September 22, 2003. In fact, Capmark believes it likely that the August 7, 2003, joint inspection was requested by HUD, to allow them the opportunity to assess the physical condition of the property first hand before it issued an invitation letter. The August 7, 2003 joint inspection preceded HUD's invitation letter by a mere 46 days. Certainly not the substantial ("more than seven months") variance depicted in OIG's draft audit report, or that would support the conclusions drawn by OIG therein.

B. OIG's draft audit report cites Section 5.14 of the MAP Guide, as requiring *"another site inspection if the joint inspection was performed several months in advance of the firm application"*. Section 5.14 of the MAP Guide actually reads as follows {emphasis added}:

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> In addition to the exhibits indicated in Paragraph 5.5, the mortgagor shall submit the following exhibits for the Lender's architectural analyst to review:
>
> A. Detailed scope of rehabilitation work resulting from joint inspection. (See Paragraph 5.16)
>
> B. If an abnormal amount of time has elapsed since the joint inspection, or if property damage may have occurred, reinspect the property to determine current physical condition and provide any necessary additional conditions for Firm Commitment.

Comment 13

Section 5.14 of the MAP Guide appears to address additional exhibits that the mortgagor must submit to the lender's architectural analyst, as opposed to requiring the lender or its architectural analyst to reinspect the property. Moreover, Section 5.14 provides that the property should be reinspected if an abnormal amount of time has passed since the joint inspection or if property damage may have occurred. Based on Capmark's prior experience with MAP substantial rehabilitation projects, as well as the complexity of the planned scope of work for the subject property, we do not agree that the elapsed time between the joint inspection and submission of the firm application was abnormally long, warranting a reinspection of the property.

C. The MAP Guide clearly places responsibility on the mortgagor's architect to provide a detailed scope of work. In a letter dated 07/23/03 to [redacted] the mortgagor's consultant, the mortgagor's architect states: "*...we have spent a considerable amount of time on site, investigating existing conditions in order to figure out what we have to work with. This has been done as a coordinated effort between our office,* [redacted] *and his subcontractors.*" Subsequent to the date of that letter, on August 7, 2003, Capmark's architectural and cost analyst met on site with the mortgagor's architects, as well as [redacted] (HUD Project Manager) and [redacted] (HUD Appraiser) to conduct the joint inspection of the property, during which all parties agreed to the basic scope of rehabilitation work for the property. If the mortgagor's architect believed the scope of work to be inadequate, he had an absolute duty to inform the other participants during the joint inspection, and should be held accountable for any failure to do otherwise.

Comment 14

Article 2 of the Standard Form of Agreement Between Owner and Architect for Housing Services (AIA Document B181) charges the mortgagor's architect with the responsibility for reviewing the owner's program "*...to ascertain the requirements of the Project...*", and to prepare design documents "*...appropriate for the Project.*" {emphasis added}

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OIG's draft audit report states: *"Because the inspection was performed earlier than HUD's preapplication approval* (by 46 days) *and Capmark did not require an additional site inspection, the owner's architectural drawings and specifications did not address all of the property's rehabilitation needs. Instead, the* (mortgagor's) *architect prepared drawings and specifications that generally matched the May 12, 2003 basic work write-up* (also prepared by the mortgagor's architect) *and did not include additional needed repairs identified by the contractor and the owner's architect while they were on site."* {emphasis and annotations added}

Comment 14

It is inappropriate and unsupportable to suggest that the absence of another site inspection by Capmark had any bearing on the mortgagor's architect's final plans and specifications.

D. Considerable attention has been given to two letters which purport to show evidence that Capmark had been told by the mortgagor's architect and the original proposed contractor that the work scope did not include, according to the OIG, *"many vital repairs needed by the project"*. The first letter is the aforementioned communication from the mortgagor's architect to [redacted] dated 07/23/03 (again, prior to the date of the joint inspection on August 7, 2003), which includes a discussion of the condition of the hot water piping – suggesting replacements and changes that would *"increase the total project cost in excess of $200,000."* However, following closer examination and consultation with Capmark's architectural and cost analyst, it becomes clear that the statements made by the mortgagor's architect relate specifically to a proposal to use an alternative space heating system using the existing hot water lines to heat the apartments. Indeed, based on the cost of upgrading the water heating system, the mortgagor's architect concludes that he feels *"we need to continue with the originally intended system"*; i.e., resistance heating (new heat pumps). The letter concluded that it was *"unfortunate in that we will leave the project with hot water piping problems..."* Capmark's architectural and cost analyst reported that the problems were judged to be manageable and not untypical of properties of this age.

The second letter, dated 10/08/03, was written by [redacted] of Espo Construction Company (the original proposed contractor). to [redacted] of Capmark. Copies of the letter were transmitted via e-mail to the mortgagor, mortgagor's architect, [redacted] the management agent, Capmark's architectural and cost analyst, and others. OIG's draft audit report states: *"The contractor wrote that there were uninhabitable units, which were not in the contractor's estimate, that the hot water piping had significant problems, and that some units had water heaters that did not work. The contractor explained that the project*

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was located in a high theft area and that some units had been cannibalized." {emphasis added}

Below are several pertinent statements from [redacted] 10/08/03 letter:

- *"It has come to our attention that there are approximately 30 some units that are down for various reasons that are not in our estimate."* {emphasis added}
- *"Hot water piping in general apparently has continued to experience* significant *failures, this may affect the cost of the original 45 down units."*
- *"It has been brought to our attention since the original estimate there has been theft and cannibalism. Further this applies to the original down units that we bid. We will be revising our bid to reflect these to have our scope as* accurate *as possible."* {emphasis added}
- *"There is a potential for additional cost associated with Code compliance resulting from substantial replacement of drywall."*
- *"There is a potential for additional cost associated with termite damage repair and dry rot repair."*

Comment 15

[redacted] use of the term "down" is unclear, since it was known that in addition to the 45 units requiring substantial rehabilitation there were a number of units that were simply unrentable due to the failure of the HVAC. Suffice to say that confusion regarding the meaning of the terms "down", "offline", "uninhabitable", and "unrentable" has flourished during the multiple reviews of the subject transaction by various parties.

Despite [redacted] assertion that he would be *"revising our bid to reflect these to have our scope as accurate as possible"*, the work list provided by the original proposed contractor dated 02/12/04 reflected a scope of work nearly verbatim to the mortgagor's architect's work write-up. It may also be worth noting that [redacted] firm, Espo Construction Company, final bid was significantly over budget and was subsequently replaced by the mortgagor prior to initial endorsement.

Comment 16

E. OIG's draft audit report further asserts that Capmark's narrative *"did not report that the project had significant hot water problems and had twelve missing or inoperable water heaters"*.

While Capmark has already offered an explanation for the mortgagor's architect's statements regarding the hot water piping in its letter of 07/23/03, Capmark

Comment 16

Comment 8

Comment 14

Comment 8

believes OIG's statement regarding *"twelve missing or inoperable water heaters"* is referring to the nine new hot water heaters and three new hot water heaters, provided for in HUD approved change orders #1 and #4, respectively. In a memo dated October 15, 2004, the mortgagor's architect responded to questions posed by [redacted] (HUD Project Manager) regarding the proposed change orders. In the memo the mortgagor's architect explains: *"As construction commenced, it was determined that the placement of 9 additional new water heaters would provide a better distribution of hot water and a longer useful life of the hot water distribution systems* (hot water piping). *Further, between the time that the plans were developed, several of the existing water heaters to remain exhibited failures, due to weather exposure and lack of use."* {emphasis and annotations added) Rehabilitation projects commonly experience unforeseen conditions that arise during construction, which is why this project had a contingency reserve to cover the costs of necessary change orders approved by HUD. Given the timeline described in the mortgagor's architect's explanation for the twelve water heaters, it is hard to fathom how Capmark would have been in a position to report in its narrative that the project had "twelve missing or inoperable water heaters".

F. Capmark acknowledges receipt of rent rolls for the project showing 78 "Down/Offline" units as of 10/31/03 and 87 "Down/Offline" units as of 11/03. However, the mortgagor provided the mortgagor's architect, Capmark, and Capmark's architectural and cost analyst a list of forty-five units that required rehabilitation due to water damage from the failure of the heating and cooling systems, as well as a sewer line backup. The remaining units shown on the rent roll as "Down/Offline" couldn't be leased due to the lack of heat and air conditioning. The plan to utilize project funds for these "make-ready" units not in the scope of work was found by Capmark to be acceptable, as according to the management company, make-ready repairs (such as painting, carpet cleaning, etc.) were all that were necessary to prepare the units for tenancy and would be accomplished by their staff so the units would be available to lease as soon as the heating and cooling systems were replaced. The mortgagor's relocation plan was to move existing tenants into other units as the HVAC systems were installed, and to lease up each building as heating and air conditioning became available.

What is noteworthy is the project rent roll dated 09/30/04 (just sixteen days following initial endorsement), which revealed that occupancy had fallen to 7.8% from the 41.73% reflected on the rent roll dated 02/20/04. Occupancy continued to decrease and by December, 2004, all 254 units were reported vacant. The facts are undeniable – prior to initial endorsement nearly all of the tenants vacated the property. The mortgagor knew at the time of closing that the property lacked sufficient cash flow to meet the underwritten operating expenses during substantial rehabilitation. Neither the mortgagor nor the management agent

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notified Capmark of the substantial decline in project occupancy prior to initial endorsement. It should be noted that HUD's MAP program does not require borrowers to provide an updated rent roll on existing projects immediately prior to closing, which may have disclosed the change in occupancy.

OIG Finding: HUD Recognized a Loss After Asbury Defaulted on the Loan

HUD has already recognized a loss of more than 5.249 million. This amount could increase to more than $5.9 million. Asbury defaulted on its mortgage on September 1, 2005, before reaching final endorsement. On March 1, 2006, Capmark assigned the mortgage note to HUD. By February 28, 2007, HUD had paid more than $8.745 million to settle Capmark's claim, sold the note for more than $3.378 million and received $117,430 in interest income from the GNMA bonds that financed the loan, a loss of more than $5.249 million.

Capmark did not pay the general contractor $684,698 after it certified that it completed the rehabilitation and after HUD had completed the cost certification. As a result, the general contractor put a lien on the property and is working to recover the $684,698 from HUD. Capmark should reimburse HUD for any amounts paid on the general contractor's claim. This will protect the FHA funds from a potential $684,698 additional loss on this loan.

III.Capmark's Response

Comment 17

A. Capmark was not in a position to pay the general contractor, as HUD prohibits further advances of mortgage proceeds while a loan is in default. Nevertheless, in response to reported threats of litigation against HUD by the general contractor's attorney, Capmark sent a letter dated 12/16/05 to HUD discussing several options that might facilitate a payment to the general contractor, including a scenario whereby Capmark might advance its own funds to pay the contractor in reliance upon certain assurances from HUD that it would be reimbursed under any subsequent mortgage insurance claim. It should be noted that construction related costs do not fall under the typical expenses that an FHA lender is expected to absorb during a period of default and in contemplation of an insurance claim (such as taxes, property insurance, etc.), therefore any such undertaking would be at Capmark's discretion.

Following several subsequent telephone conversations with HUD regarding the conditions under which Capmark might be willing to advance its own monies to pay the general contractor, HUD issued a letter dated 01/19/06 authorizing Capmark to pay the general contractor and certain other vendors. Capmark's counsel determined that HUD's letter lacked specificity regarding certain HUD rules and regulations thought to be needed to ensure proper handling of the advance under Capmark's anticipated mortgage insurance claim. Following further review and investigation, Capmark's counsel drafted a letter for Capmark to send to HUD which, upon acknowledgement by HUD, would address the issues omitted from HUD's letter of 01/19/06. A draft of said letter was sent to HUD on February 15, 2006 for review and comment. On February 28, 2006, HUD communicated to Capmark that it was reconsidering whether or not it wanted to authorize payment to several of the vendors identified in its original 01/19/06 letter.

Capmark, in anticipation of agreeing to HUD's request to advance its own monies to pay certain construction-related payments, took additional steps on its own to safeguard Capmark and HUD in connection with the transaction, including: 1) contacting the title insurance company to investigate the process under which the payments could be made through the title company and the title conditions related thereto; 2) confirming with the general contractor that certain vendors' mechanics liens questioned by HUD were for work outside of the construction contract; and, 3) requesting the mortgagor confirm the remaining payments proposed by HUD to be "valid and continuing obligations of the mortgagor".

At the same time all this was going on, Capmark was completing a loan default analysis of the transaction, which had begun to reveal concerns of possible violations. In light of these discoveries, Capmark felt it inappropriate to advance monies to the general contractor and others before HUD was made aware of Capmark's findings. Capmark's Mortgage Default Review was sent to the LQMD team leader on March 31, 2007, with a copy transmitted to Mr. Tom Miller. Several days later, on April 6, 2007 Capmark was contacted by Mr. Lavern Hester, Acting Director - Multifamily Program Center, and Ms. Jennifer Takagi, Supervisory Project Manager, both of the Oklahoma City HUD Field Office, inquiring about the status of HUD's request that Capmark advance its own funds to pay the general contractor and others. Learning of Mr. Miller's unfortunate passing, HUD reported no knowledge of Capmark's Mortgage Default Review. Following a lengthy discussion, during which Capmark made it clear that it was still willing and able to advance its own monies to pay the proposed expenses should HUD wish to proceed following its review of Capmark's Mortgage Default Review, which was e-mailed to both Mr. Hester and Ms. Takagi that same day. HUD never reaffirmed its request to pay the

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general contractor and Capmark's claim under HUD's contract for mortgage insurance was finally settled on May 24, 2006.

B. Under the circumstances, Capmark doesn't understand the rationale for the OIG's statement: *"Capmark should reimburse HUD for any amounts paid on the general contractor's claim"*. A closer examination of the various scenarios should bring to light Capmark's confusion:

Scenario #1: Project does not go into default as actually took place, but instead proceeds to final endorsement as originally contemplated, at which time all obligations identified in mortgagor's cost certification as "to be paid" (including amounts due general contractor) are paid from mortgage proceeds. Subsequent to final endorsement the project goes into default and Capmark's claim under HUD's contract for mortgage insurance is increased due to the final advance of mortgage proceeds. Net effect – HUD pays general contractor.

Scenario #2: HUD authorizes Capmark to advance its own funds to pay the general contractor in reliance upon assurances that Capmark will be reimbursed for said payments under its mortgage insurance claim. Net effect – HUD pays general contractor.

Scenario #3: HUD agrees to pay general contractor following Capmark's assignment and final claim settlement. Net effect – HUD pays general contractor.

Why OIG believes that Capmark is somehow liable to HUD for any payment it might make to the general contractor is unknown.

OIG Finding: Conclusion

Capmark did not practice due diligence when underwriting the Asbury loan. Further, it lacked sufficient policies and procedures to comply with HUD requirements. It did not inform HUD of vital information, did not document that it had thoroughly analyzed Asbury's financial condition and did not identify needed property rehabilitation. As a result, it recommended a loan that defaulted before final closing, causing HUD a loss of more than $5.249 million and could cause an additional loss of $684,698 if not reimbursed by Capmark.

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IV. Capmark's Response

Comment 1

A. Capmark did practice due diligence and disclosed to HUD both the physical and financial difficulties suffered by the property that would be remedied with the proposed substantial rehabilitation. HUD's issuance of a Firm Commitment following their receipt and review of the sponsor's current financial statements evidences HUD's acceptance of the sponsor's financial condition and its commitment to provide continued support for the future operations of the project.

Comment 14

B. The scope of work for the substantial rehabilitation was developed by the mortgagor, their consultant and their architect and it was their responsibility to provide an adequate scope of work.

Comment 8

C. The mortgagor knew at the time of the initial endorsement in September, 2004, that the project lacked sufficient occupancy to cover its operating expenses; much less then the 44% starting occupancy used in the underwriter's initial operating deficit analysis. Within days of the initial closing, requests were being made for release of operating deficit monies which quickly depleted those funds. The facts of this case should not be overlooked by HUD, but instead used constructively.

Comment 18

Capmark recommends that HUD consider modifying its MAP program requirements to require an updated certified rent roll on all existing projects immediately prior to closing. Such a requirement may have disclosed the substantial change in occupancy in this case, delaying closing until the project's financial needs were reassessed.

Comment 19

D. The Introduction to Capmark's Quality Control Plan Policies and Procedures states, *"Capmark Finance FHA Division's policies and procedures are not designed to supplant the HUD MAP Guide, but are furnished as an outline with emphasis on the responsibility for the tasks rather than the specific performance thereof. Each individual in the Division has on-line access to and is expected to be familiar with the HUD MAP Guide, HUD regulations and any administrative requirements for their particular function. The Capmark Finance documentation is not intended to define each sequential step, but to broadly identify the work process, quality control and approval requirements"*. It would be redundant to develop internal policies and procedures pertaining to the underwriting or to the analysis of financial statements when the MAP Guide already provides them.

Comment 1

In summary, Capmark believes that it acted appropriately and responsibly in its underwriting of this case. Our underwriting was consistent with HUD and MAP program requirements and guidelines and we strongly deny any assertion that Capmark misled or misrepresented the Asbury Square transaction to HUD. A review of our application

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documents and supplemental communications with HUD confirms that Capmark disclosed to HUD all material facts and circumstances surrounding this transaction which Capmark was aware of, or could have been reasonably expected to be aware of. Accordingly, we do not believe there is any basis for a claim against Capmark in connection with this loan.

We remain available should you wish to discuss this matter further.

Sincerely,

Dean W. Wantland

Dean W. Wantland
Senior Vice President

dww:

Attachments:

Exhibit A - Capmark's Mortgage Default Review for Asbury Square

Exhibit B - Asbury Square Aged Payables Schedule dated February 27, 2004

OIG Evaluation of Auditee Comments

Comment 1 Capmark recommended HUD insure the loan. Inherent in the recommendation was Capmark's assurances that the loan was economically sound and an acceptable risk to HUD. HUD relied upon Capmark's recommendation when it insured the loan. HUD expected Capmark's recommendation to be based upon its due diligent evaluation of the information. Capmark had sufficient information available at the time to not recommend the loan. If Capmark would have obtained and evaluated the required or additional information, Capmark should not have recommended the loan for HUD insurance. We maintain that Capmark should reimburse HUD for the losses sustained as a result of its reliance upon Capmark's unsupported recommendation.

Comment 2 We clarified this in the report.

Comment 3 Capmark contends disclosing a negative net worth in an attachment referenced to in its underwriting narrative was sufficient. However, Capmark did not explain how the negative working capital balance would affect the financial soundness of the loan or the measures needed to reduce the risk of a negative working capital balance. Furthermore, Capmark apparently did not believe the negative working capital was a weakness as it was not included in Capmark's underwriting narrative listing of project strengths and weaknesses and still recommended the loan for insurance. Even after Capmark received the audited financial statements showing Sheltering Palms did not extinguish the debt, Capmark did not raise this as a concern.

Comment 4 Capmark had a responsibility to evaluate the integrity and accuracy of the information submitted. As alluded to in comment 1, if information submitted to Capmark contradicted previous information or raised questions, Capmark should have satisfied itself to the accuracy of the information and the effect on its recommendation to insure the loan. To our knowledge, Capmark never disclosed its concerns or the contradictory information to HUD until its March 2006 mortgage default review.

Comment 5 We clarified this in the report.

Comment 6 During our fieldwork, Capmark did not inform us that the aged accounts payable was corrupted when we asked for it. Further, HUD did not have it in the firm commitment application package submitted by Capmark. Capmark did not include an analysis of the accounts payable in its underwriting narrative. As a result, we maintain that HUD did not receive it as required by the MAP Guide. For our analysis, we used the December 31, 2003 aged accounts payable provided by the management agent. This information would have been available to Capmark.

Comment 7 Although Capmark's underwriting narrative disclosed as a weakness "current vacancy problems caused by HVAC and 45 down units." Capmark also dismissed this one weakness with "HVAC and electrical problem will be corrected with proposed rehab."

Comment 8 In its 2004 underwriting narrative, Capmark provided a table of Asbury's 2001 monthly occupancy rates, which ranged from 100 percent to 83.5 percent. However, below the 2001 table, Capmark stated the February 2004 occupancy as 41.73 percent or 148 vacant units (103 more units than the 45 planned for rehabilitation). Capmark did not list the 148 vacant units as a weakness in its underwriting narrative or provide an analysis of the vacancies on the economic soundness of the loan. Further, a review of the rent rolls from 2003 and 2004 would have revealed the downward occupancy trend discussed in Capmark's response.

Comment 9 While Capmark planned an initial operating account to cover deficits caused by future costs, it did not have provisions for Asbury to pay its existing overdue debts or to pay for needed repairs that were not in the rehabilitation plan. Furthermore, its estimate failed to take into account the decreasing occupancy trend.

Comment 10 We addressed this in our audit titled "Aberdeen Villa Apartments, Formerly Asbury Square Apartments, Tulsa, Oklahoma, FHA #118-35200, Spent Almost $35,000 in Project Funds on Ineligible and Unsupported Costs." Audit report number 2007-FW-1006, issued March 7, 2007.

Comment 11 The MAP guidelines required the lender's architectural and cost staff, the borrower's architect, and the general contractor to take part in the joint inspection. Neither Capmark nor its architect provided any records showing that the general contractor took part in any of the site inspections, including the August 7, 2003 inspection.

Comment 12 We used the January 31, 2003 inspection because it was referenced in Capmark's underwriting narrative and was supported in its files.

Comment 13 As noted in its response, another inspection must take place if property damage may have occurred. While Capmark's response is correct that the mortgagor was responsible for providing the exhibits, Capmark was responsible for gathering and evaluating the exhibits and making a recommendation to HUD as to whether or not to insure the loan.

Comment 14 Capmark had a fiduciary responsibility to obtain and evaluate relevant information. If it did not believe the information to be sufficient then it should have obtained the necessary information. Capmark's response references an architect's scope of work that took place approximately eight months prior to Capmark's recommendation to insure the loan. We maintain that Capmark had sufficient information provided to it between July 2003 and March 2004 to raise questions as to the adequacy of the scope of work. For instance, while maintaining that the additional plumbing work needed was "manageable" and "not untypical," Capmark's analysis did not include how the property would pay for the correction of the problems.

Comment 15 Again, Capmark had a fiduciary responsibility to obtain and evaluate relevant information. If it did not understand something provided, it should have clarified prior to making a recommendation to HUD to insure the loan.

Comment 16 We have clarified this in the report.

Comment 17 We maintain that HUD would not have insured the loan if Capmark did not recommend insuring the loan. Capmark's unfounded recommendation to insure the loan caused HUD's loss, including the $5.2 million loss already incurred and the potential $684,698 loss that HUD could incur.

Comment 18 We would also agree with the recommendation, but we are not aware of any requirement that would preclude Capmark from requiring current rent rolls on loans that it recommends for HUD insurance.

Comment 19 We maintain that it is important to incorporate the MAP Guide into Capmark's quality control plan and procedures.

Appendix C

PROJECT TIMELINE	
DATE	**DESCRIPTION**
January 31, 2003	Site inspection
May 7, 2003	Lender’s architect inspected the property
July 21, 2003	Pre-application received by HUD
August 7, 2003	Lender’s architect inspected the property
September 22, 2003	HUD invitation to submit firm application
October 8, 2003	The general contractor told Capmark that the work scope would not completely rehabilitate the property
December 31, 2003	Appraisal completed
January 7 thru February 20, 2004	First extension for firm application
February 19, 2004 to March 20, 2004	Second extension for firm application
March 11, 2004	New underwriter assigned for Asbury
March 15 to March 31, 2004	Third extension for firm application
March 22, 2004	Capmark received Asbury’s December 31, 2003, unaudited financial statements
March 29, 2004	Capmark submitted the underwriting narrative
March 30, 2004	HUD received the underwriting narrative
July 6, 2004	Firm commitment issued
July 30, 2004	Underwriting narrative revised for the new contractor
August 10, 2004	Firm commitment revised
September 9, 2004	Firm commitment revised
September 14, 2004	Initial endorsement
September 1, 2005	Project defaulted on the mortgage loan
October 7, 2005	Project cost certification completed
December 15, 2005	Capmark elected to assign the mortgage to HUD
February 1, 2006	HUD acknowledged Capmark 's election to assign the mortgage to HUD
March 1, 2006	Mortgage assigned to HUD
After March 1, 2006	HUD paid partial settlement of $6,022,016 (of $8,745,708 total claim) to Capmark
May 24, 2006	HUD paid the remaining $2,723,692 (of $8,745,708 total claim) to Capmark
December 6, 2006	HUD sold Asbury Square for $3,378,864
February 28, 2007	GNMA bond interest of $117,430 paid to HUD