



U.S. Department of Housing and Urban Development
Office of Inspector General
Pacific/Hawaii District
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Audit Memorandum
00-SF-123-0801

February 10, 2000

MEMORANDUM FOR: Lily A. Lee, Director, Santa Ana Homeownership Center, 9JHH

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

SUBJECT: Limited Review - REO Division Operations

INTRODUCTION

We conducted a limited review to evaluate the internal control procedures in place for disposing of HUD-acquired single family properties at: (1) the former HUD Los Angeles (LAAO) Real Estate Owned (REO) Division during the time that a scheme involving the sale of REO properties at well below the appraised value was perpetrated by a HUD housing specialist; (2) the Santa Ana Homeownership Center (HOC) REO Division and, (3) the Management & Marketing (M & M) contractor, Golden Feather. The purpose of the review was to determine the adequacy of the internal control procedures at LAAO that allowed the scheme to occur and whether adequate internal control procedures are in place at the Santa Ana HOC and Golden Feather to minimize the likelihood that the scheme could reoccur.

SUMMARY

A Housing Specialist, at the GS 12 level, was able to arbitrarily mark down the selling price of HUD owned properties because there was insufficient supervision. While HUD regulations require price reductions to be justified and signed off by the Chief Property Officer, that requirement was not being followed. Over our seven month test period, the Housing Specialist ignored appraisals and lowered the selling price for 47¹ properties. The reductions for the 33 ranged from 38% to 91%. The selling price for these properties totaled \$1,034,750, or \$3,007,062 lower than the appraisal. HUD's nationwide goal is to sell properties at 98% of appraised value. Based on this 98% goal, these arbitrary reductions by this one Housing Specialist cost the insurance fund almost \$3 million for the 33 cases reviewed.

¹ We only included 33 cases in our calculation because appraisal reports for the other 14 cases were missing. Had the 14 additional cases been included, the estimated cost to the insurance fund would have been higher.

In addition, we believe that the CPO did not provide adequate supervisory oversight of the housing specialists to ensure that they disposed of REO properties in accordance with program requirements. We evaluated the internal control procedures at Golden Feather and found that those procedures are adequate to minimize the possibility that the scheme could reoccur. However, to sufficiently minimize the risk, we believe, that improvements are needed in the Santa Ana HOC's monitoring of Golden Feather in order to ensure compliance with the established procedures and to best safeguard HUD's interests.

BACKGROUND

The Federal Housing Administration's (FHA) Single Family Mortgage Insurance Program helps low and moderate income families purchase homes by reducing downpayments and lender fees. FHA insures the loans on the homes. HUD acquires single family properties (one-to-four family residential units) as a result of foreclosure of FHA-insured mortgages or special acquisitions. Following foreclosure, mortgage lenders have the right to deed the properties to the Secretary of HUD in exchange for the mortgage insurance benefits.

HUD disposes of acquired properties through its Property Disposition Program, administered by the Office of Single Family Housing REO Division. Its mission is to reduce the property inventory in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the mortgage insurance funds.

In February 1993, HUD initiated a reinvention effort to streamline operations and reduce costs. HUD began reducing program staff and consolidating its mortgage insurance processing, claims, and property disposition activities from the field offices into four Homeownership Centers (HOC), located in Santa Ana, California; Denver, Colorado; Atlanta, Georgia; and Philadelphia, Pennsylvania. The Santa Ana HOC opened in February 1998; however, it did not fully assume the responsibility for REO operations until August 1998.

Effective March 29, 1999, HUD contracted out for the management and marketing of properties which are owned by, or in the custody of, HUD. These M & M contractors assumed full responsibility for the management and marketing functions. Golden Feather was awarded the contract for properties in Southern California. HUD's primary role is to monitor the M & M contractor's compliance with its contract.

In December 1999 federal prosecutors in Los Angeles, California, filed criminal charges against a HUD housing specialist and a real estate company owner to whom she allegedly sold HUD REO properties at well below their appraised values. In exchange, the Housing Specialist accepted about \$80,000 in bribes and an automobile from the real estate company owner. These sales took place between September 1997 and March 1998 before the REO workload was assumed by the HOC. Both the Housing Specialist and the real estate company owner have agreed to plead guilty to bribery and income tax reporting violations.

OBJECTIVE

The objective of our review was to evaluate the internal control procedures in place for disposing of REO properties:

1. At the former LAAO REO Division during the time that the HUD housing specialist perpetrated the scheme, and to determine the extent to which these procedures were being followed, which allowed the scheme to occur; and
2. At the Santa Ana HOC REO Division and the M & M contractor, Golden Feather, to determine whether adequate procedures are in place to minimize the likelihood that the scheme could reoccur.

SCOPE AND METHODOLOGY

To accomplish our objective, we performed the following:

- ✓ Reviewed pertinent laws, regulations, HUD Handbooks, HUD M & M contractor monitoring guidelines, M & M contractor procedure manuals, and other directives related to REO operations;
- ✓ With regard to the former Los Angeles Area Office (LAAO) REO Division, we:
 - Interviewed the former REO Chief Property Officer to obtain an understanding of the established procedures and internal controls in place for disposing of REO properties;
 - Reviewed a sample of case files for REO properties processed by the REO Division to verify whether staff complied with established procedures; and
 - Reviewed case files for REO properties that were involved with the HUD housing specialist's scheme to identify the areas where the breakdown in the internal controls had occurred.
- ✓ At the Santa Ana HOC REO Division, we:
 - Interviewed the REO Director, the two branch chiefs, and other selected staff to obtain an understanding of the established procedures in place for disposing of REO properties through the use of M & M contractors and monitoring the M & M contractor's compliance with its contract; and
 - Reviewed the assessment reports and supporting documentation to evaluate the adequacy of the HOC's monitoring of the M & M contractor.

✓ At Golden Feather, we:

- Interviewed the Vice President, and Contract Manager to obtain an understanding of the procedures and internal controls in place for disposing of REO properties; and
- Reviewed a sample of cases to verify whether staff followed the established procedures.

We performed the audit field work between January 11 - 21, 2000. The scope of our review generally covered January 1997 through December 1999.

WORKLOAD STATISTICS

During calendar years 1997, 1998, and 1999, REO property sales closed for Los Angeles were as follows:

Los Angeles REO Properties - Closed Sales		
Period/Office	Closed Sales	Monthly Average
Los Angeles Area Office:		
Jan. - Dec. 1997	4,238	353
Jan. - Dec. 1998	4,344	362
Jan. - March 1999	1,516	505
TOTAL	10,098	374
Golden Feather:		
Apr. - Dec. 1999	12,188	1,354

REVIEW RESULTS

We found that the HUD Housing Specialist was able to perpetrate the scheme involving the sale of REO properties at well below the appraised values because the LAAO had deviated from the internal control procedures established in the pertinent HUD handbook requiring the CPO to approve all sales contracts and price reductions. In addition, we believe that the CPO may not have performed adequate supervisory oversight of the housing specialists to ensure that they disposed of REO properties in accordance with program requirements. We evaluated the internal control procedures at Golden Feather, and found that those procedures are adequate to minimize the possibility that the scheme could reoccur. However, to sufficiently minimize the risk that the scheme could reoccur, we believe, that improvements are needed in the Santa Ana HOC's monitoring of Golden Feather in order to ensure compliance with the established procedures and to best safeguard HUD's interests.

Review of the former LAAO REO Procedures and Practices.

We found that the HUD housing specialist was able to perpetrate the scheme involving the sale of REO properties at well below the appraised values because the LAAO had deviated from the

internal control procedures established in the pertinent HUD handbook requiring the Chief Property Officer (CPO) to approve all sales contracts and price reductions. In addition, we believe that the CPO may not have performed adequate supervisory oversight of the housing specialists to ensure that they disposed of REO properties in accordance with program requirements.

HUD Handbook 4310.5, *Property Disposition Handbook - One to Four Family Properties*, REV-2, provides program policy and processing requirements for HUD's Single Family Property Disposition Program (SFPD). In Chapter 1 of the Handbook, it stresses the importance of internal control procedures as an integral part of SFPD processing. The Handbook further states that the SFPD internal control structure in the Handbook is established to provide reasonable assurance that appropriate financial management and programmatic objectives are achieved, which includes: (1) maximizing the return on SFPD activities to the FHA fund; (2) safeguarding of single family properties; (3) maintaining accurate and complete accounting records; and (4) preventing and detecting fraud, waste, or mismanagement by SFPD staff, contractors, or other related parties. The exhibit at the end of the chapter provides a matrix of responsibilities for the SFPD. In the exhibit it states that the Chief Property Officer (CPO), with the assistance of the Director of Housing Management or Field Office Manager, is responsible for ensuring appropriate segregation of duties, as required by internal control objectives throughout the handbook. Among other responsibilities, the CPO is responsible for approving sales contracts, and also for approving all reductions in price and/or terms of the disposition program.

We reviewed 47 REO property case files identified by the Federal Bureau of Investigation (FBI) as cases which were involved in the HUD housing specialist's scheme, to determine where there was a deviation in the internal control procedures that allowed the scheme to occur. Our review of the documentation in the case files disclosed generally two different schemes that occurred between September 1997 and March 1998. In the first scheme, a particular real estate broker would submit overly high bids on behalf of his clients to be assured that they would be the highest bidders. The corresponding sales contracts were approved by either the CPO or the housing specialist. Later, however, the real estate broker's clients canceled their bids for various reasons. Instead of re-listing the properties to solicit new bids, as required, the real estate broker submitted new sales contracts, in the name of one of his entities, Family Home Information Center, with significantly reduced purchase prices, which were then approved by the housing specialist. In the second scheme, which also involved properties in which the initial purchasers had canceled their bids, the housing specialist approved sales contracts, at significantly reduced purchase prices, in the name of a particular individual, instead of re-listing the properties. Therefore, because the housing specialist was authorized to approve the sales contracts, the improper sales went undetected by the CPO.

We interviewed the former CPO to determine the reasons why the housing specialists were allowed to approve the sales contracts, which was contrary to the Handbook. According to the former CPO, the housing specialists were already authorized to approve sales contracts when he became the CPO in April 1996. The CPO said that he did not question the practice because he was not aware of the Handbook requirement and assumed that the authorization could be delegated to the housing specialists because the practice was already in place when he became the CPO. However, the former CPO said that even if he had been aware of the requirement, he would have

continued the practice because of the high volume of REO properties in LAAO's inventory. The former CPO said that it was a local office policy to approve all sales contracts within 24 hours to expedite the sales processing. Thus, the former CPO said that it would have created a bottleneck had he been the only person that could approve the sales contracts. During 1998, the CPO's supervisor verbally changed the policy, and required the CPO to be the primary person approving the sales contracts; however, housing specialists were also still authorized to approve sales contracts.

In addition, we believe that a contributing cause was that the former CPO may not have performed adequate supervisory oversight of the housing specialists to ensure that they disposed of REO properties in accordance with program requirements. According to the former CPO, the housing specialists generally controlled the entire process and that he did not review individual property case files unless there was a specific problem. The former CPO said LAAO's goal was to reduce its inventory, so his focus was to review properties that were not selling. In our opinion, the CPO may have been able to detect the improper sales if he had periodically reviewed sales price comparison reports from SAMS, which would have disclosed the significant differences between the list prices and sales prices.

Review of Golden Feather Procedures and Practices.

We also reviewed Golden Feather's procedures and practices for disposing of REO properties to determine whether adequate internal control procedures are in place to minimize the possibility that the scheme could reoccur. Based on our interviews with officials, review of procedures manuals and review of a sample of cases, we concluded that the procedures were sufficient to minimize the likelihood that the scheme could reoccur. Specifically, we found that Golden Feather had segmented its operations into functional areas, based on the different phases of the property sales process. For example, the Contracts Department was responsible for properties that were ready to list for sale, through the acceptance of the sales contract. Within the Contract Department, the work duties were further segregated to separate the bid listing, bid receipt, bid review, sales contract review, and sales contract approvals. Thus, contrary to the situation at the former LAAO REO Division, the work was segregated and control procedures were in place to detect errors or improper practices.

Review of Santa Ana HOC Monitoring Procedures and Practices.

We also reviewed the Santa Ana HOC REO Division's procedures and practices for monitoring Golden Feather. Based on our interviews with officials and staff, review of monitoring procedures and review of issued assessment reports, we believe that improvements are needed in the Santa Ana HOC REO Division's monitoring of Golden Feather in order to ensure compliance with the established procedures and to best safeguard HUD's interests. Our review disclosed that there is no assurance that the REO Division is monitoring the assessed areas identified in the monitoring guidelines and it is unclear what types of reviews are performed each month. The REO Division was unable to provide us with documentation supporting what file reviews were performed, what verifications were made of Single Family Acquired Asset Management System (SAMS) data, or what complaints were investigated and resolved. The responsible REO Branch Chief, generally agreed that they do not review all areas in the monitoring procedures each month

because of time constraints. Instead, each month, specific areas of concern are targeted for review. We believe that HUD's monitoring of Golden Feather is an integral control procedure for assuring compliance with program requirements. Specifically, we believe that conducting file reviews and verifying SAMS data are important monitoring functions that would detect the reoccurrence of the HUD housing specialist's scheme.

AUDITEE COMMENTS

At the exit conference, Santa Ana HOC officials generally agreed with the results of our review. The HOC Director agreed that the monitoring procedures needed improvements and said that the procedures have been evolving over time because the HOC and M&M contracting are new.

RECOMMENDATIONS

We recommend that you:

1. Evaluate the propriety of the former CPO's failure to follow prescribed Handbook procedures for approving REO sales and inadequate supervisory oversight of the housing specialists,
2. Based on the results of your evaluation recommended in 1 above, take appropriate administrative action, and
3. Develop and implement changes to the REO Division monitoring procedures to better document the:
 - specific review areas planned for each assessment period, how the reviews will be accomplished, the staff assigned to conduct the reviews; and justification for any changes,
 - results of the reviews performed (either positive or negative); and
 - resolution of any deficiencies identified during the monitoring.

* * * *

Within 60 days, please furnish us with 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.

Should you have any questions, please contact Ruben Velasco, Assistant District Inspector General for Audit at (213) 894-8016.

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