Issue Date
June 21, 2004
Audit Case Number
2004-SE-1005

TO: Michael L. McCullough, Director, Office of Multifamily Development, HTD

FROM: Frank E. Baca, Regional Inspector General for Audit, 0AGA

SUBJECT: Quality Controls and Underwriter Accuracy under Multifamily Accelerated Processing at Continental Securities LLC, Syracuse, NY

INTRODUCTION

We completed an audit of Continental Securities, LLC's performance under the Multifamily Accelerated Processing (MAP) program. Our objective was to determine the accuracy of Continental Securities' underwriter estimates, and if there are adequate management and quality control procedures in place to ensure that loans processed under the MAP program comply with Departmental requirements.

To obtain information on MAP loans originated by Continental Securities, we interviewed, as needed, project management, appropriate HUD and Mortgagee staff, and other parties involved in the transaction. We also examined files and records of the mortgagee, mortgagor, Buffalo Multifamily Hub, and Columbia County Industrial Development Agency to assess the accuracy of the underwriter's estimates.

Our review covered six FHA insured loans. These loans represent all available projects with sufficient operating history that were underwritten by Continental Securities using MAP Processing through the HUD Buffalo Multifamily Hub (a brief description of these six loans is provided in Appendix A). We performed our fieldwork primarily at the HUD Buffalo Multifamily Hub and the offices of Continental Securities in Syracuse, New York intermittently between September 2003, and February 2004. We conducted the audit in accordance with generally accepted government auditing standards.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please provide us, for each recommendation without a management decision, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me at (206) 220-5360.

SUMMARY

Continental Securities' underwriter estimates of project occupancy, revenue, and expenses were essentially accurate in four of the six loans we reviewed; one loan had inaccurate estimates (Hudson Valley Care) and one project had no actual data for comparison since it did not achieve operational status (Amber Court Apartments). However, Continental Securities did not have adequate management and quality control procedures in place to ensure that loans processed under the MAP program complied with Departmental requirements. Continental Securities did not correctly analyze a construction contractor's financial capability, and allowed financing in excess of HUD's limits. Consequently, Continental Securities submitted at least two loans for FHA insurance that resulted in multi-million dollar losses to the Department. By authorizing a MAP Lender to prepare much of the documentation for a loan submission for mortgage insurance, HUD places confidence in the Lender's integrity and competence. However, in the process of performing this work, Continental Securities placed HUD at risk.

We recommend that HUD seek indemnification of loans for Amber Court Apartments and Hudson Valley Care, and determine whether the Lender and Underwriters should retain the authority to use the MAP process.

BACKGROUND

Continental Securities, LLC

Continental Securities, LLC was formed in 2000 and assumed the loan originating activities of its predecessor, Continental Securities Corporation. Continental Securities is in the mortgage brokerage business, specializing in multifamily financing, and is an FHA approved mortgagee and Government National Mortgage Association (GNMA) approved securities issuer. Operations are conducted primarily in Syracuse, NY with additional offices in White Plains, NY. During 2002 and 2003, Continental Securities' origination activities consisted solely of multifamily mortgages.

Multifamily Accelerated Processing - MAP

Federal Housing Administration (FHA) multifamily mortgage insurance began in 1937 and has been a major source of financing for affordable housing since that date. HUD processes multifamily loan insurance applications through 51 Multifamily Hubs and Program Centers throughout the nation. In some of these Hubs and Program Centers, the volume of work in recent years created increasing delays in processing. Furthermore, lenders were unable to get a tentative decision on a multifamily loan application early in the HUD review process.

To achieve faster processing and more timely decisions, some Hubs and Program Centers, developed "fast-track" processing. Under fast-track, qualified lenders had the option of preparing FHA forms and doing preliminary underwriting for certain multifamily loan applications. Approximately 30 of the 51 Hubs and Program Centers were using some form of this fast-track processing for some of their multifamily loan applications. Fast-track processing was not consistent from one Hub to the next, and was not available in many of the multifamily processing offices.

Multifamily Accelerated Processing (MAP) is a new processing procedure that grew out of fast-track. The intent of MAP is to establish national standards for approved lenders to prepare, process, and submit loan applications for FHA multifamily mortgage insurance. It is also intended to establish a process that is consistent at each HUD multifamily processing office, and to provide lenders an earlier review of the application for insurance on new construction and substantial rehabilitation. The MAP process is also expected to significantly reduce the amount of HUD review time, while striking a careful balance between expedited processing and ensuring an acceptable level of risk for HUD's multifamily mortgage insurance programs.

FINDING 1

CONTINENTAL SECURITIES PLACED HUD AT RISK BY NOT FOLLOWING MAP REQUIREMENTS

As the lender, Continental Securities placed HUD-insured funds at risk by not following MAP requirements, and submitted two loans for FHA insurance that resulted in significant losses to the Department. For the Amber Court Apartments loan, Continental Securities did not properly analyze a construction contractor's financial capability. For the Hudson Valley Care Center loan, Continental Securities allowed financing in excess of HUD's limits.

Amber Court Apartments

Continental Securities did not properly analyze a construction contractor's financial capability

Applications for FHA mortgage insurance under MAP require an architectural analysis, cost estimate, valuation analysis, mortgage credit review, environmental review, and management analysis of the property. The MAP Lender's underwriter must review these documents and certify that the proposed loan represents an acceptable risk to HUD. In the mortgage credit review, the underwriter analyzes the ability of the contractor to complete the project. Part of this analysis includes determining that the contractor has adequate working capital.

The MAP Guide requires the underwriter to use his experience in accounting, his ability to analyze financial statements, and his knowledge of lending practices to determine the contractor's ability to complete the project. To that end, the MAP Guide requires the underwriter to analyze the contractor's working capital. Although the MAP Guide describes "working capital" as simply the difference between current assets and current liabilities, the generally accepted industry practices that FHA lenders must follow call for an analysis of current assets.

In the mortgage credit review for Amber Court Apartments, Continental Securities' underwriter determined that the contractor's working capital exceeded the project's required working capital and reported to HUD that the contractor had adequate financial capacity for the project. HUD used this information in its decision to approve the loan.

Our audit found that the underwriter did not follow generally accepted industry practices for analyzing current assets. Specifically, the underwriter included amounts due from company officers and receivables from affiliates as current assets, even though industry practices do not consider these items as current assets, because such loans often do not represent a liquid asset convertible to cash and available for business operations. The underwriter told us he calculated the working capital by subtracting the contractor's current liabilities from the current assets as reported on the December 31, 2000 financial statement. While the contractor's financial statement showed current assets of $1,628,918, our review found that $833,594 of those assets were amounts due from officers and affiliates. If these amounts are removed from current assets, the contractor does not have sufficient working capital to meet MAP Guide requirements. Therefore, the underwriter should not have recommended the loan for mortgage insurance.

Because the contractor's working capital is directly dependent upon the liquidity of the current assets, we believe the underwriter should have analyzed the liquidity of those assets, especially in light of the information available to him. For example, a Loan Receivable Officers/Shareholders for $480,000 was listed on the contractor's balance sheets as a current asset from 1998 through 2000, even though "current assets" are defined as those expected to be realized within a year. Also, the MAP Guide requires the underwriter to review the contractor's Aging Schedule of Notes Receivable that has the names, payment terms, maturity dates, and the current portions of the notes. However the underwriter told us he inadvertently neglected to obtain this required schedule.

Because of insufficient working capital, the contractor failed to complete the rehabilitation, resulting in the project's default and a loss to HUD of over $3.4 million. The construction schedule called for the first building to be completed in December 2001 with all 12 buildings completed by July 2002. HUD documents show the first building was not ready for occupancy until May 2002. Without a revenue stream, the project defaulted. HUD settled the claim for $4,615,713 and sold the note for $1,424,572, resulting in a $3,413,971 loss on the project, including fees and costs.

Hudson Valley Care Center

Continental Securities Underwrote a Loan Exceeding FHA Financing Limits

Section 8.10.B of the MAP Guide requires that secondary financing provided by a state or local government agency not exceed the difference between the HUD insured mortgage and the HUD fair market value of the property.

The Hudson Valley Care purchase transaction had financing totaling $23,630,000, including $23,145,000 in bonds issued by the Columbia County Industrial Development Agency (Agency), which is a state agency according to a HUD attorney. The Agency authorized $18,900,000 of Series A bonds secured by the FHA-insured mortgage, and $4,245,000 of unsecured Series B secondary bonds. We found no source documentation for the $485,000 at either Hudson Valley Care or Continental Securities nor could either provide a consistent explanation of the source of that amount.

Financial Instrument	Amount
Secured Series 'A' Bonds	$18,900,000
Unsecured Series 'B' Bonds	4,245,000
Other - Undetermined	485,000
Total Amount	$23,630,000

The $4,245,000 in secondary bond financing exceeded the MAP Guide secondary financing limit for this loan by over $2 million. The Continental Securities President told us that the debt was an obligation of the Columbia County Industrial Development Agency and was not secondary financing for Hudson Valley Care. However, our review of bond documents disclosed that Hudson Valley Care is responsible for repayment and that the Agency assigned its rights to the bond holder. The bond holder collects directly from Hudson Valley Care and has legal recourse to pursue repayment in the event of default. Further, Hudson Valley Care listed the bonds as a liability in its 2002 financial statements.

Because secondary financing from a governmental agency exceeded the difference between the HUD-insured mortgage amount and the fair market value of the project, Continental Securities should not have recommended the Hudson Valley Care application for mortgage insurance. Hudson Valley Care owners defaulted on the loan in December 2002 after making eight monthly payments on the 35-year mortgage. HUD sold the note for $ 8,999,999, resulting in a $ 9,854,880 loss on the project, including fees and costs.

Continental Securities' Actions Demonstrated a Negligent Disregard For HUD Requirements

The issues discussed above show that MAP application packages did not receive adequate internal review and approval at Continental Securities. Continental Securities' policies state the originator, as well as another managing member, are to review applications; however, there was no documentation of the review. As a result, we noted frequent instances of corrective action requested by HUD staff on loans Continental Securities submitted for FHA insurance. Those instances include significant oversights, such as failure to establish a sinking fund and omission of comparable sales information in an appraisal. Continental Securities staff prepares a list of requested corrections to assist in identifying all requirements for future applications, but the procedure is not documented in the Quality Control Plan, or how this is used in the review process. Overall, Continental Securities' Quality Control Plan primarily contains statements of policy, but contains fewer descriptions of processes used to implement or document how these policies are accomplished.

In our opinion, Continental's lack of adequate internal review and approval of MAP loan applications evidenced negligence and a disregard for HUD requirements.

AUDITEE COMMENTS AND OIG EVALUATION

Continental Securities responded to our draft report in a May 24, 2004 letter (shown in its entirety in Appendix C).

Auditee Comments – Amber Court Apartments

Continental Securities strongly disagreed with the finding and stated that "…any loss suffered was due solely to the failure to enforce the provisions of the performance bond that the general contractor was required, and did in fact post. Had the owner, lender or HUD enforced their rights under the performance bond, the project would have been completed and the debt repaid."

In addition, Continental Securities stated that there was no evidence at the time of underwriting the loan that the general contractor lacked the financial capability to fulfill its obligations under the contract:

- The Surety did an intensive review and must have concluded the contractor had financial capability or a bond would not have been issued.

- The audit report concludes that the underwriter was negligent in properly computing "working capital." However, the MAP guide does not require special tests in making this calculation or suggest that certain assets be excluded. Also, although the Code of Federal Regulations states that industry practices are to be followed, nowhere are these practices delineated.

- The contractor's independent CPA firm properly classified the $480,000 as a current asset, and generally accepted accounting principles state that for a shareholder loan to be classified as a current asset the CPA firm has to determine it was either likely to be paid in one year or that the shareholder had the financial ability to repay the loan if a demand for repayment was made.

- The project was previously reviewed by HUD to determine if the MAP Lender adhered to the requirements of the MAP Guide and to statutory and regulatory requirements. HUD's report mentions some relatively minor matters, but it did not mention any problems or concerns about whether the underwriter correctly applied industry standards in assessing the working capital of the general contractor.

<u>OIG Evaluation of Auditee Comments – Amber Court Apartments</u>

Continental Securities cannot abdicate or seek to shift responsibility of its underwriting obligations. Continental Securities' argument that the Surety is solely to blame assumes that the performance bond carrier would or could complete the project in time to prevent default. The bond carrier did not complete the project, even though the owner issued a demand to that effect in May 2002 after the contractor abandoned the project and defaulted under the terms of the construction contract. HUD correspondence indicates that the bonding company refused to complete the project after the project defaulted in November 2002. We maintain that the default occurred because the contractor did not deliver the buildings on schedule due to a lack of working capital. The underwriter deviated from standard industry practice when he determined the contractor had adequate working capital.

A HUD official told us that "Analyzing Financial Statements," by the American Bankers Association contains the standard industry practices for lenders. This publication states in part:

> "Due from officers/partners. This noncurrent asset account represents a company loan to one of its officers or owners. Although such loans are usually shown as an account receivable on financial statements, such loans often to not represent a liquid asset convertible to cash and available for business operations. Company officers normally pay the company last because they own part of the company. Therefore, the loan officer should shift such loans from accounts receivable to the noncurrent asset category . . . Loans to company officers should be examined closely by the lender to determine whether the officer has sufficient personal liquidity to repay this receivable. This is particularly important if the company must depend on repayment of the loan for needed liquidity."
>
> "Due from affiliated concerns. Affiliated companies are those related by common ownership, either one owning the other or both companies owned by the same individual or other company. Amounts due from affiliates, like those due from officers or partners, are usually disclosed as an account receivable on the company's financial statements. However this receivable may be non-liquid because of the nature of the affiliation and the absence of pressure to pay such debts. Thus the loan officer should consider it as a noncurrent asset."

We also disagree with Continental Securities' assertion that there is no evidence the general contractor lacked financial capability to fulfill its obligations under the contract. Our review disclosed that:

- The contractor's FY 2000 financial statements showed a net loss of over $440,000,
- Amounts due from company officers, shareholders, and affiliates went from 21 percent of current assets in 1996 to over 51 percent in 2000,
- Amounts due from company officers, shareholders, and affiliates went from 27 percent of other assets in 1996 to over 82 percent in 2000,
- Cash and cash equivalents decreased from $347,000 in 1999 to $137,448 in 2000,
- The FY 2000 financial statement showed a new receivable from officers in the amount of $199,699.

In addition, there was evidence to demonstrate that the contractor in fact did not have adequate capital to invest in the project, including:

- HUD correspondence stating the project was 25 percent behind schedule three months after starting, with no significant progress being made.
- A letter from an Amber Court sub-contractor stating that a supplier had placed a credit hold on the contractor's orders for materials for non-payment. The sub-contractor also expressed concern about payment for services.
- An account history from an Amber Court supplier showing the contractor owed over $24,000 as of February 2002 dating back to November 2001.
- Correspondence from the owner's architect stating the contractor repeatedly failed to supply enough skilled workers, pay subcontractors for material and labor, and provide wage rate documentation.
- A Mechanic's Lien against the project for non-payment in March 2002.
- An owner's architect's letter terminating the contractor for failure to pay sub-contractors for material and labor and for walking off the job in May 2002.
- A bankruptcy filing by the contractor in August 2002.

The HUD review of the project discussed in the auditee's comments did not include a review of Continental Securities' mortgage credit files. The review was conducted using HUD files, which include only some of the records relating to the lender's mortgage credit review.

<u>Auditee Comments - Hudson Valley Care Center</u>

Continental Securities stated that:

1. The cause of the default was solely attributable to the loss of Medicaid/Medicare reimbursement for the nursing home caused by a care issue in the Hudson Valley's ventilator unit that adversely impacted the cash flow.

2. HUD clarified section 8.10.B of the MAP Guide we used as criteria to allow government secondary financing, in combination with the primary financing, to exceed 100 percent of fair market value.

3. It is critical to note that Section 8.15 of the MAP Guide states that the underwriter is not to review financing documents associated with mortgage bonds in a bond-financed project, and that HUD personnel were also instructed not to review these financing documents.

4. The report only mentions $4,245,000 of Series B bonds, and that no explanation could be found for the $485,000 of required funds at closing. They state that an amended bond resolution issued the bonds for $4,500,000 and that this accounted for most of the $485,000 that was unaccounted for.

<u>OIG Evaluation of Auditee Comments – Hudson Valley Care Center</u>

1. Regardless of the cause of the default, Continental Securities approved a loan that it should not have, and HUD suffered significant monetary losses as a consequence. However, Continental Securities' assertion that the care issue was the sole cause of the default is questionable. Hudson Valley did not achieve its net income projections even prior to the loss of Medicaid/Medicare reimbursement, primarily because of inaccurate expense projections. The HUD appraiser expressed concerns regarding expense projections, but was assured by the lender that they were being attained. However, actual expenses for 2001 were $10,344,373, exceeding the $9,298,667 estimate provided to HUD two weeks earlier by over one million dollars. The loan closed two full months into the next year, but the lender did not consider the more current information. The undisclosed increase in actual expenses would have reduced the maximum insurable mortgage to $11,502,800 according to the debt service ratio method. The lender failed to exercise due diligence in monitoring and disclosing the project's incurred costs, despite the concerns expressed by the HUD appraiser.

2. HUD currently allows secondary financing involving governmental agencies to exceed the fair market value of the property. However, this was a revision of Section 8.10 of the MAP Guide, not a clarification as Continental Securities claims. This revision took effect subsequent to the Hudson Valley transaction. In an FAQ, HUD stated "After further consideration, the revised policy on secondary financing (loans), grants, tax credits and gifts applies to MAP profit and nonprofit insurance applications that have not been endorsed as of this FAQ posting date." The FAQ posting date was October 7, 2003, whereas the Hudson Valley loan closed on February 28, 2002.

However, even if the revised HUD policy been in effect at the time of the Hudson Valley transaction, the loan would still have been in violation of HUD requirements, as well as questionable in its substance:

> * The rules in 8.10.B clearly state that when using secondary financing provided by a Federal, State, or local government agency or instrumentality, no other form

of financing may be used. Continental Securities' application only disclosed the use of private secondary financing, which the application limited to 92.5 percent of the fair market value, according to the rules in 8.10.B. Continental Securities did not disclose the remaining secondary financing bonds to HUD.

* A lien must be disclosed and approved by HUD according to MAP Guide Section 8.10, the mortgagee certificate, and the regulatory agreement. Also, secondary loans from a Federal, State or local government agency or instrumentality are also subject to significant disclosure requirements in MAP Guide Section 8.11. Both sections require a review by HUD legal counsel, which was not performed. We found no evidence of these disclosures, including the use of Form FHA-1710, Residual Receipts Note, and inclusion of specific language required by MAP Guide Section 8.10.C. in the notes and secondary bonds.

* We question whether the $4,245,000 in undisclosed secondary bonds constitutes a bona fide loan from the Columbia County Industrial Development Agency. We did not see a transfer of funds from the Columbia County IDA in the closing documents. The secondary bonds only served to document the seller's loan to the buyer. The funds were created during closing from the seller's equity and then became the buyer's downpayment.

3. Continental Securities is correct regarding Section 8.15 review requirements for mortgage bond financing. However, 8.15 does not apply to secondary bond financing, as evidenced by specific procedural and disclosure requirements for secondary bond financing in Sections 8.10 and 8.11. Continental Securities' inclusion of secondary financing with the mortgage bond transaction effectively resulted in nondisclosure of the secondary financing.

4. The amended bond resolution approved $4,500,000 of Series B bonds, but only $4,245,000 were issued according to information provided by Columbia County Industrial Development Agency, the bond underwriter's closing statement, and a reconciliation provided during our audit by Continental Securities. Those documents also refer to the $485,000 as subordinate secondary notes. Further, the application acknowledges the intent to issue subordinate secondary notes, predominantly to the seller. Continental Securities implies that at least part of the $485,000 represents bonds from Columbia County IDA, accounting for most of the difference between the $4,500,000 and $4,245,000. However, Continental Securities can provide no documentation to support this, and Columbia County IDA told us they had no knowledge of the $485,000 bond.

RECOMMENDATIONS

We recommend that the Director, Multifamily Development:

1A. Seek indemnification of the loans for Amber Court Apartments and Hudson Valley Care Center.

1B. Determine if the MAP Lender and Underwriter should retain the authority to use the MAP process.

MANAGEMENT CONTROLS

In performing our review, we considered the management controls relevant to Continental Securities' operations to determine our audit procedures, not to provide assurance on those controls. Management controls in the broadest sense include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. Officials of the audited entity are responsible for establishing effective management controls.

We determined that the following management controls were relevant to our survey objectives:

- Quality Control Review Process
- MAP Lending Loan Origination Process

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives.

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

> Continental Securities does not have adequate internal review and approval controls over MAP application packages.

Appendix A

BACKGROUND OF SELECTED LOANS

1. Hudson Valley Care Center (aka Green Manor Nursing Home) (FHA# 014-22022) is a Section 232, subject to 223(f) property located near Hudson, New York. The property was purchased by a newly formed nonprofit from a for-profit owner. The nonprofit's sponsor is a private individual. The purchase transaction used mostly tax-exempt bonds to finance the entire cost of the purchase, of which $18,900,000 was FHA insured. Green Manor Nursing Home has 120 skilled nursing beds and 80 assisted living beds. Forty of the skilled nursing beds are ventilator units.

2. Amber Court Apartments (FHA #014-35137) is a Section 221 (d)(4) property located in Horseheads, New York. The purchaser is a private party, who planned a substantial rehabilitation of the property, and arranged financing of $6,232,900. The property consists of a dated 151-unit apartment complex.

3. Seabury Woods (FHA #014-43152) is a section 232 property located in Gates, New York. The project includes $7,410,000 in tax exempt bond financing for new construction of 48 assisted living units and 22 Alzheimer's/special care units by a large nonprofit sponsor.

4. Unity Health Systems' St. Mary's Residence Facility (FHA #014- 22026) is a Section 221 (d)(4) property located in Rochester, New York. The sponsor is a major nonprofit, who planned to restructure debt with tax exempt bonds and buy out a prior affiliate through a refinance of $20,700,000. The facility includes 120 licensed skilled nursing beds, inpatient psychiatric services accommodating 40 licensed beds, inpatient physical and psychiatric rehab accommodating 33 beds (predominately head trauma injuries), and community service facilities and agencies.

5. Westwood Village (FHA #014- 22021) is a Section 232, subject to 223(f) property located in West Seneca, New York. The owner is a private party, who planned to consolidate debt through a refinance of $8,160,000. The borrower retired $2.55 million of loans he previously made to the company. Half was turned to equity and half turned to cash-out. The facility consists of 112 assisted living units.

6. Mary Agnes Manor (FHA #014- 22029) is a Section 232, subject to 223(f) property located in Buffalo, New York. The owner is a private party who used the $4,969,400 transaction to refinance existing debt, provide funds for refurbishment, replace several mechanical components, and establish a reserve fund. The facility is licensed to accommodate 230 adult care beds but has a current capacity of 224 beds and some Alzheimer's or Memory care specific units.

Appendix B

SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

Recommendation Number	Type of Questioned Cost Ineligible 1/	
	$ 3,413,971	Amber Court Loss
	9,854,880	Hudson Valley Care Loss
1A.	$13,268,851	Total Loss

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.

AUDITEE COMMENTS

CONTINENTAL SECURITIES, LLC

May 24, 2004

Via Federal Express
Mr. Frank Baca
U.S Department of Housing and
Urban Development
Office of the Inspector General for Audit
Region 10
909 First Avenue, Suite 126
Seattle, Washington 98104-1000

Re: Draft Audit Report-Continental Securities, LLC

Dear Mr. Baca:

Thank you for sending to us the draft audit report referenced above (the "Audit Report"). Per your request, please accept this letter as our written comments on the Audit Report. For ease of reference, this letter will use the same terms which are used in the Audit Report.

First, we were pleased that no problems were discovered in four of the six loans that were reviewed. As to the two loans with respect to which perceived problems were discovered, our comments are as follows:

Amber Court Apartments

We strongly disagree with the conclusion set forth in the Audit Report that the underwriting of this loan was in any way responsible for the loss suffered by HUD. Rather, we feel it is very clear that any loss suffered was due solely to the failure to enforce the provisions of the performance bond that the general contractor was required, and did in fact, post. Had the owner, lender or HUD enforced their rights under the performance bond, the project would have been completed and the debt repaid.

As stated and as required by HUD regulations, the general contractor was required to, and in fact did, post both a payment and a performance bond. The bonds were obtained from a surety company (the "Surety") on the U.S. Treasury Department list of approved surety companies. The performance bond required the

Surety to complete the project if the general contractor was unable to complete it for any reason. As one might suspect, since the Surety is responsible if the general contractor gets into financial difficulty, the Surety subjects the general contractor to a rigorous financial review prior to issuing either the payment bond or the performance bond. Obviously, in the instant case, the Surety made the decision that the general contractor had the financial wherewithal to complete the project.

Continental has no first hand information as to what actually happened with respect to the general contractor. However, assuming the Audit Report accurately reports that the general contractor encountered financial difficulty, the owner, the lender or HUD had the right, and perhaps the obligation, to demand the Surety complete the project within the terms of the original contract with the general contractor. For some unknown reason, that apparently was not done in the instant case. The failure to call on the Surety to fulfill its obligations is the sole and exclusive reason that HUD suffered a loss in the instant case. The loss was in no way due to the actions of the underwriter.

Furthermore, there is simply no evidence that at the time of underwriting of the loan, the general contractor lacked the financial capability to fulfill its obligations under the contract. As stated, the Surety did an intensive review of the financial condition of the general contractor and must have concluded that it had the financial capability required or a bond would not have been issued. Since the Surety is liable in the event the general contractor fails, this review would be much more thorough and complete than any review required to be undertaken by an underwriter.

The Audit Report focuses on one aspect of the general contractor's financial condition to reach its conclusion that the underwriter was negligent in performing its duties. That aspect was the proper computation of "working capital". As the Audit Report correctly states, the MAP Guide defines working capital as current assets minus current liabilities. The MAP Guide does not direct the underwriter to perform any special tests in making this calculation nor does it direct or suggest that the underwriter exclude certain assets in making this computation. Although the CFR may direct that industry practices are to be followed, nowhere are these practices delineated. Nonetheless, the Audit Report criticizes the underwriter for including in the calculation of working capital "amounts due from officers and receivables from affiliates as current assets, even though industry practices do not consider these items as current assets, because loans often do not represent a liquid asset convertible to cash and available for business operations." This criticism misses the mark on a number of fronts.

First, as stated above, the Surety performed its own analysis of the financial condition of the general contractor, presumably using the same information available to the underwriter, and concluded the general contractor had the financial ability to complete the project. Second, the independent certified public accounting firm employed by the general contractor in its reviewed financial statements determined that under generally accepted accounting principles the loan receivable in the amount

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of $480,000 was properly classified as a current asset as of December 31, 1999. The footnotes to the 1999 financial statement show that this was not an oversight by the accounting firm but rather was a conscious decision after careful analysis. The fact that the loan receivable was shown as a current asset from 1998 through 2000 is not determinative of its classification as a current asset. Under generally accepted accounting principles, for a shareholder loan to be classified as a current asset the certified public accounting firm had to determine it was *either* likely to be paid in one year or that the shareholder had the financial ability to repay the loan if a demand for repayment was made. The accountants, using their independent judgment, determined in the instant case that the loan was properly classified as a current asset. It should be noted that the footnotes to the reviewed financial statements indicated that the note was secured by stock in another company owned by the shareholder.

Furthermore, this project was previously reviewed by HUD and an LQMD Report was issued by Kerry J. Mulholland on December 11, 2002. The purpose of the report was to determine whether the MAP Lender adhered to the requirements of the MAP Guide and to statutory and regulatory requirements. At the time the LQMD Report was issued the loan was in default. Although the LQMD Report mentioned a number of relatively minor matters, it no where mentioned any problems or concerns with whether the underwriter correctly applied industry standards in assessing the working capital of the general contractor.

In summary, the only cause of the loss suffered by HUD on the Amber Court Apartment loan was the failure of either the owner, the lender or HUD to demand the Surety timely complete the project. Furthermore, the Surety, which had the largest financial risk, independently determined that the general contractor, which had been in business since 1920, had the financial ability to complete the project. It does not seem fair or reasonable to criticize the underwriter for failure to reclassify a loan receivable as a non-current asset when the certified public accounting firm, which had far more access to financial information and to the management of the general contractor, had previously made the determination that the loan receivable was properly classified as a current asset.

Hudson Valley Care Center

At the outset, it must be noted that the cause of the default on this loan had absolutely nothing to do with the underwriting of the loan. The cause of the default was attributable solely to the loss of Medicaid/Medicare reimbursement for the nursing home. Subsequent to the closing of the loan, there was a care issue in the ventilator care unit of the project. The ventilator care unit produced strong cash flow for the borrower. This care issue resulted in the New York State Department of Health suspending the admission of new patients to the nursing home until the care issue was resolved. The result of this suspension was a decrease in the number of patients in the nursing home with a particularly significant decrease in the number of patients in the ventilator care unit. This had a severe impact on the cash flow of the

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facility and was the sole cause of the default. Particularly important is the fact that no payments were ever made on the secondary financing. Therefore, there is no factual basis on which to allege that any underwriting issues were in any way responsible for the default in this loan.

As a preliminary matter, we disagree with the assertion in the Audit Report that Section 8.10B of the MAP Guide requires that secondary financing provided by a state or local governmental agency not exceed the difference between the HUD insured mortgage and the fair market value of the property. This Section was clarified to provide as follows:

> Subordinated liens against the property that result from a secondary loan from a Federal, State, or local governmental agency or instrumentality to cover non-mortgageable costs and/or equity, in combination with HUD's primary lien, may exceed 100% of the property's Fair Market Value or Replacement Cost

This clarification merely confirmed the commonly understood meaning of this Section of the MAP Guide and, for a number of years, it has been common practice for bond financed deals to exceed the fair market value of the project. Given the above quoted language, Continental was under the impression that the bonds issued by the local Industrial Development Agency (which, as stated in the Audit Report, is an agency of the State of New York) could, in fact, exceed 100% of the fair market value of the property[1].

Furthermore, it is critical to note that Section 8.15 of the MAP Guide specifically states that the underwriter is *not* to review financing documents associated with mortgage bonds in a bond financed project. It is also our understanding that the HUD personnel also were instructed not to review these financing documents.

The Audit Report also mentions that only $4,245,000 of Series B Bonds were issued and that no explanation could be found for $485,000 of the required funds at the closing. However, pursuant to an amended Bond Resolution dated February 5, 2002, the amount of the Series B Bonds to be issued was $4,500,000 and not $4,245,000. This accounts for the majority of this discrepancy.

As stated, the only reason for the default in the repayment of the Hudson Valley loan was care problems experienced in the ventilator care unit. Additionally, since all of the secondary financing was provided by a state agency and represented either owner's equity or non-mortgageable costs, under Section 8.01B of the MAP Guide the total financing could exceed 100% of the fair market value of the property.

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[1] Continental did not participate in the bond financing which closed after the HUD insured loan. However, it is our understanding that the IDA Bonds were a lien on the property, subordinate to the HUD insured mortgage.

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In conclusion, Continental is willing to work with HUD, as it always has been, to strengthen its underwriting standards and procedures if deficiencies do exist. However, there is no basis on which to assert that the alleged mistakes made by Continental were the reason there was a default on these two loans or that Continental in any way acted in "negligent disregard for HUD requirements". Therefore, we strongly disagree that there exists any legal basis on which to assert that Continental should indemnify HUD for the losses suffered. The simple fact is there is no causal connection between the alleged underwriting errors, even if such errors did in fact occur, and the defaults on these loans and no legal basis to assert a claim for indemnification. To assert that Continental has an indemnification obligation in a published report when the facts clearly show that there is no legal basis for making such a claim is not only unfair, it does great damage to Continental's reputation. Hopefully, you will reconsider your position in this regard.

Furthermore, we also disagree that because of perceived issues in two of the six loans examined, that Continental should lose its authority to use the MAP process. This recommendation ignores the many loans, involving millions of dollars, which were underwritten by Continental and which have experienced no problems. To state that the perceived problems show a disregard for HUD requirements is an overstatement of the nature and extent of the problems identified.

We will be happy to meet with you again to discuss any of the foregoing points. In the meantime, if you have any questions please contact the undersigned.

Very truly yours,

CONTINENTAL SECURITIES, LLC

By: ______________________
Bradley R. Grainger

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Appendix D

DISTRIBUTION OUTSIDE OF HUD

The Honorable Joseph Lieberman, Ranking Member, Committee on Government Affairs
The Honorable Susan M. Collins, Chairman, Committee on Government Affairs
The Honorable Thomas M Davis, III, Chairman, Committee on Government Reform
The Honorable Henry A. Waxman, Ranking Member, Committee on Government Reform
Elizabeth Meyer, Senior Advisor, Subcommittee on Criminal Justice
Clinton C. Jones, Senior Counsel, Committee on Financial Services
Kay Gibbs, Committee on Financial Services
Mark Calabria, Committee on Banking, Housing, and Urban Affairs
W. Brent Hall, U.S. General Accounting Office (HallW@GAO.GOV)
Steve Redburn, Chief Housing Branch, Office of Management and Budget
Linda Halliday, Department of Veterans Affairs, Office of Inspector General