Issue Date
September 27, 1999
Audit Case Number
99-NY-221-1007

TO: Morris E. Carter, Director, Single Family Home Ownership Center, 3AHH
Philadelphia, Pennsylvania

FROM: Alexander C. Malloy, District Inspector General for Audit, 2AGA
New York/New Jersey

SUBJECT: Alliance Mortgage Banking Corp.
Non-Supervised Mortgagee
Rochester, New York

We completed an audit of the books and records of Alliance Mortgage Banking Corporation (Alliance), Rochester Branch Office, Rochester, New York. We selected this Branch Office because 62 of 65 Section 203 (k) loans that were made to one investor (borrower) were in default as of April 1998. Our audit consisted of a detailed review of 22 of the 62 loans. We found that Alliance's Rochester Branch Office did not comply with all of the U.S. Department of Housing and Urban Development/Federal Housing Administration HUD/FHA requirements pertaining to Section 203 (k) loans.

Within 60 days, please provide us 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 not considered necessary. Also, please furnish us copies of any correspondence or directives issued related to this audit.

If you or your staff have questions, please contact William H. Rooney, Assistant District Inspector General for Audit, on (212) 264-8000, extension 3976.

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Executive Summary

We completed an audit of the books and records of Alliance Mortgage Banking Corp., Rochester Branch Office, Rochester, New York a non-supervised mortgagee. The objective of the audit was to determine whether Alliance originated Section 203 (k) loans in accordance with the requirements of the U.S. Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA), which requires adherence to prudent lending practices. Our audit consisted of an examination of 22 loans that Alliance made to one investor (borrower) during the period between May 1996 and July 1997. All 22 loans were in default as of April 1998. A summary of the results of our examination is provided below.

Audit Results

We reviewed 22 HUD/FHA insured Section 203 (k) loans that were originated by Alliance and made to one individual investor (borrower). We concluded that Alliance neither properly administered all the Section 203(k) program rehabilitation funds nor adhered to prudent lending practices when processing the HUD/FHA Section 203 (k) loans. Specific instances of non-compliance are discussed below:

Our review disclosed that Alliance did not ensure that: (a) a borrower was competent to perform rehabilitation work; (b) a borrower was only reimbursed for the actual cost of the rehabilitation work; (c) rehabilitation repairs were complete; (d) costs were eligible before releasing contingency rehabilitation funds to a borrower; and (e) controls over the accounting of rehabilitation escrow funds were adequate. We believe that Alliance's failure to follow the Section 203 (k) requirements were due to lack of management oversight. As a result, HUD/FHA's risk of potential losses on insured loans greatly increased.

In addition, our review disclosed that Alliance underwrote at least 12 of the loans in our sample without ensuring that the borrower had sufficient funds to close the loans. In this regard, our review disclosed that the borrower used rehabilitation funds from other Section 203 (k) loans to actually close at least nine of the loans in our sample. This occurred because Alliance's staff did not ensure that the loans were processed in accordance with all of the HUD/FHA requirements. Because HUD/FHA relied on Alliance's underwriting process, Alliance caused HUD/FHA to incur an unnecessary risk by insuring these

loans. At the completion of our field work all 12 loans with mortgage amounts totaling $590,150 were in default.

Recommendations

We recommend that Alliance be referred to the Mortgagee Review Board and that appropriate administrative sanctions be taken against Alliance.

Exit Conference

The results of our audit were discussed with Alliance Officials during the course of our audit and at an exit conference held on August 24, 1999. The exit conference was attended by:

Alliance Officials

John Murphy, President
Kathleen Coughlin-Glanz, Senior Vice President
Lisa Welch, Underwriter
Maria Merrit, Alliance Underwriter

HUD-Office of Inspector General

William H. Rooney, Assistant District Inspector General for Audit
Garry D. Clugston, Senior Auditor
Patrick C. Anthony, Senior Auditor

Alliance Officials disagree with our Findings. Their written comments on the Findings are included in Appendix A of this report. In addition, our summary of their comments are included at the end of each Finding along with our evaluation of their responses.

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Abbreviations

FHA	Federal Housing Administration
HUD	U.S. Department of Housing and Urban Development
OIG	Office of Inspector General

Introduction

Alliance Mortgage Banking Corp. (Alliance) is a non-supervised mortgagee with its Headquarters located in Levittown, New York. Alliance originates loans in New York at five Branch Offices. One of these Branch Offices, the Rochester Branch Office, underwrites loans in the Rochester and Buffalo, New York area. The Rochester Branch Office is located at 1225 Ridgeway Avenue, Rochester, New York.

Alliance originates HUD/FHA Single Family insured loans, including Section 203(k) loans. The 203(k) program is HUD/FHA's primary program for the rehabilitation and repair of single family properties. The program enables a borrower to finance both acquisition and rehabilitation of a property with one loan. Alliance's Rochester Branch Office through the direct endorsement program originated 65 Section 203 (k) loans to one investor (borrower) during the period January 1989 through July 1997. As of April 1998, 62 of these 65 loans were in default with mortgage amounts totaling $2,958,618.

Audit Objective

Our audit objective was to determine whether Alliance originated Section 203(k) loans in accordance with HUD/FHA requirements and prudent lending practice.

Audit Scope and Methodology

We obtained background information by:

- Reviewing relevant HUD/FHA requirements and Mortgagee Letters.

- Examining records and reports maintained on HUD/FHA's Single Family Insurance System, Neighborhood Watch Early Warning System, Single Family Acquired Asset Management System and Computerized Home Underwriting Management System.

- Interviewing members of HUD/FHA's Philadelphia Single Family Home Ownership Center.

To accomplish our audit objective:

- We judgmentally selected 22 loans that were closed between May 1996 and July 1997, and were in default as of April 1998. These 22 loans had mortgage values amounting to $1,194,450. We performed a detailed examination of the files of these loans to confirm the

accuracy of the material information used as the basis for originating and closing the loans.

- Our audit procedures included: (a) reconfirmation of the borrowers' income and assets; (b) verification of selected data on the settlement statements; and (c) interviews with the investor/borrower, HUD/FHA and Alliance staff, Section 203 (k) inspectors, consultants and contractor.

- We performed exterior inspections on all 22 properties and used a HUD Contract Specialist to perform extensive interior inspections on 10 of the 22 properties.

- We reviewed Alliance's accounting records, and cancelled checks regarding our sample loans.

Our audit pertained to 22 loans that were made to an investor/borrower between May 1996 and July 1997, and were in default as of April 1998. The audit work was performed at Alliance's Rochester Branch Office, Rochester, New York. We performed the audit field work between February 1999 and July 1999 in accordance with generally accepted governmental auditing standards.

A copy of this report was provided to Alliance.

Alliance Did Not Properly Administer Section 203 (k) Rehabilitation Loan Funds

Alliance neither properly administered Section 203 (k) rehabilitation loan funds, nor complied with certain program requirements. Specifically, our review disclosed that Alliance did not ensure that: (a) a borrower was competent to perform rehabilitation work; (b) a borrower was only reimbursed for the actual cost of the rehabilitation work; (c) rehabilitation repairs were complete; (d) costs were eligible before releasing the contingency rehabilitation funds to a borrower; and (e) controls over the accounting of rehabilitation escrow funds were adequate. We believe that Alliance's failure to follow the requirements of the Section 203 (k) program was due to a lack of management oversight. As a result, HUD/FHA's risk of potential losses on insured loans greatly increased.

Background

Our review consisted of an examination of 22 loans insured under the HUD/FHA, Section 203 (k) Program that were in default. Alliance made all of these loans to one borrower during the period between May 1996 and July 1997. This borrower is considered an investor/borrower. As part of our review, we examined the loan files and performed physical inspections of the properties. To conduct some of the physical inspections, we used the services of a HUD Contract Specialist.

For 21 of the 22 loans in our sample, the borrower used the same individual (consultant) to write the specifications for the rehabilitation work items. Likewise, the borrower used that same consultant who prepared the specifications to inspect a majority of the completed work.

Competence

Alliance did not ensure that the borrower was competent to perform rehabilitation work

HUD Handbook 4240.4 REV-2, Rehabilitation Home Mortgage Insurance, paragraph 3-2 D (3) requires the mortgagee to obtain adequate documentation from a borrower when the borrower performs some or all of the rehabilitation work and the mortgagee must confirm that the borrower is competent to perform the work.

An Alliance Senior Vice President told us that the borrower was acting as a general contractor; however, Alliance did not provide adequate evidence that it adequately confirmed that the borrower was competent to act as a general contractor. During a discussion with the borrower, we found out that the borrower does not own a construction company, but acted as a general contractor. It is our opinion that if the borrower was a general contractor, we would expect to see various contracts between a general contractor and subcontractors. However, our review disclosed only one instance that the borrower had a written contract with a contractor. Furthermore, our discussions with this contractor raised questions. The contractor told us that he did not have a contractor's license, did not have prior construction experience, did not have any employees that worked for him, and did not work for anyone else.

In addition, the form HUD-9746-A, Request for Rehabilitation Funds Draw, requires a signature by a general contractor. Our review of these requests disclosed that the signature blocks were left blank. Further review disclosed that for each request, the borrower signed the request certifying that all completed work had been done in a workmanlike manner. This raised the question as to who actually performed the work, which will be explained below. Nonetheless, our review disclosed that Alliance could not provide adequate evidence that it confirmed that the borrower was competent to perform rehabilitation work.

Actual Cost

Alliance did not establish procedures to ensure that the borrower was only reimbursed for the actual cost of the rehabilitation work

Section 11 of the Rehabilitation Loan Agreement between Alliance and the borrower provides that the borrower should only request reimbursement for the actual cost of the rehabilitation work items. Any savings resulting from the reduction of actual costs will remain in the rehabilitation escrow account until the rehabilitation work is completed. The savings may be applied to cost overruns or the mortgage principal.

During our review we inquired as to who actually performed the rehabilitation work. The borrower told us that temporary individuals, such as friends, tenants,

students and people from the Russian community. Furthermore, the borrower said that the individuals who performed the work were usually paid in cash. The borrower also said that records on the cash payments were not maintained. In addition, the borrower could not remember the names of the individuals who were paid cash. As a result of this practice, we could not determine how much was actually paid for the rehabilitation work. Also, Alliance could not confirm that only actual costs were paid.

We are concerned about this issue because we found instances where monies from other Section 203 (k) rehabilitation escrow accounts were used to pay closing costs for Section 203 (k) loans, as discussed in Finding 2.

Rehabilitation Work

Alliance needs to strengthen controls over rehabilitation work

We performed physical inspections on all 22 properties included in our sample. The inspections disclosed numerous instances that Alliance disbursed rehabilitation funds for work items that were not completed or were not completed in a workmanlike manner. We attribute the cause of these deficiencies to the following: (1) the consultant hired by the borrower prepared inadequate rehabilitation work item specifications (architectural exhibits); and (2) the same consultant accepted inadequate rehabilitation work.

Mortgagee Letter 95-40, Revisions to the 203 (k) Rehabilitation Mortgage Insurance Program, provides that the mortgagee is responsible to ensure that the rehabilitation specifications are properly prepared. Section 3-2 C of HUD Handbook 4240.4 REV-2, Rehabilitation Home Mortgage Insurance, provides that the borrower must provide the mortgagee appropriate rehabilitation specifications. Also, Section 10 (3) of Mortgagee Letter 94-11, Revisions to the 203 (k) Rehabilitation Mortgage Insurance Program requires that the rehabilitation specifications include the quantity and cost estimates of each item and a complete description of the work.

Our review disclosed that the specifications did not always provide an adequate description of the scope of work needed. For example, a roof was to be replaced but the consultant did not define the amount of square footage

needed to be replaced. The consultant only provided a lump sum price. In another case, a work item specified a replacement or repair of defective siding; but, there was no description of the area that needed to be replaced or repaired. In another case, the work item specified a structurally sound porch; however, specifications did not exist describing what was to be accomplished.

Regarding work items that were not completed or not completed in a workmanlike manner, for 21 of 22 properties, we found at least one deficiency in each case. However, the work was certified by the consultant as being completed in an acceptable manner. In fact, 16 of the 22 properties that we inspected, had six or more deficiencies and seven of these properties had 10 or more deficiencies. For example, we found that painting was not always done in a workmanlike manner. In another instance, we found that the quality of vinyl tiles were a cheaper quality than that priced in the specifications. Examples of the various deficiencies are identified in Appendix B.

Contingency Funds

Alliance Improperly released contingency funds

For 13 loans, Alliance approved the release of contingency funds for the completion of additional non-health and-non safety construction items, when mortgages were in excess of 85 percent of the appraised value. Section 16 of Mortgagee Letter 94-11, Revisions to the 203 (k) Rehabilitation Mortgage Insurance Program, provides that the contingency reserve account can be used by the borrower to make additional improvements to dwellings when the mortgagee determines the following. First, it is unlikely that any deficiency which may affect health and safety will be discovered. Second, the mortgage will not exceed 85 percent of the appraised value of the property. If the mortgage exceeds 85 percent of the appraised value, the contingency reserve must be used to pay down on the mortgage principal. Out of the 22 loans in our sample, there were 18 loans where the mortgages exceeded the 85 percent appraisal value. Alliance improperly released contingency funds to the borrower in 13 of the 18 cases. Alliance's practice of releasing contingency funds was incorrect because it did not follow HUD's procedure as provided in Mortgagee Letter 94-11.

Accounting Controls

Inadequate accounting controls of rehabilitation funds

Our review disclosed problems with Alliance's controls over accounting for rehabilitation payments. In ten of the 22 loans in our sample, Alliance's accounting sheets were either incomplete or inaccurate. For most of the loans, the problem was an improper recording of inspection fees. In another case the borrower was not paid $180 due to a transposition error. We believe that the errors went undetected because Alliance did not establish adequate procedures and controls for recording and reviewing rehabilitation escrow fund accounting transactions.

Quality Control Plan

Summary

In summary, we attribute the cause of these deficiencies to Alliance's failure to provide proper management oversight, specifically not having an acceptable quality control plan. Section 1-20 of HUD Handbook 4240.4 REV-2, Rehabilitation Home Mortgage Insurance, provides that it is extremely important to properly monitor the receipt and disbursement of the rehabilitation funds. Our review indicated that Alliance's quality control reviews neither verified the adequacy of the rehabilitation specifications nor the adequacy of the completed rehabilitation work. In addition, alliance's quality control plan did not require its review team to perform these verifications.

In our opinion, Alliance did not follow prudent lending practices; therefore, we believe that Alliance should be held accountable for the fact that all 22 loans in our sample are in default. Furthermore, it should be noted that we selected our sample of 22 loans from a list of default loans closed by Alliance between May 1996 and July 1997. Our review disclosed that Alliance provided 40 other loans to the same borrower in addition to the 22 in our sample. Inasmuch as all 40 of these loans were in default, we suggest that HUD's Home Ownership Center review the loans to determine whether Alliance complied with all applicable HUD/FHA's requirements during the loan origination process.

Auditee Comments

a. Alliance Officials believed that there was no reason to conduct a formal approval of the borrower because Alliance was aware of the borrower's qualifications and experience. Also, Alliance had first hand knowledge of the renovations that the borrower had successfully completed.

b. Alliance Officials believed that the borrower was acting as a general contractor. As such, Alliance believes that there are no provisions prohibiting a contractor from making a profit.

c. Alliance called for additional third party inspections to ensure that the properties were complete, safe, and habitable. Also, Alliance Officials believed that the consultant who certified to the completed work was competent and the third party inspections satisfied Alliance that the work was completed.

d. At the exit conference Alliance personnel explained that none of the loans identified in the report exceeded 85 percent of the loan to value amount. As such, Alliance personnel believed that the contingency funds could have been used for additional work items.

e. Alliance Officials stated that the improper recording of inspection fees were the additional inspections fees. They were not set out on the accounting overview sheets because there was no place to show deductions for additional inspection fees. There was a transposition error of $180.00 that Alliance did not realize, nor did the borrower/ investor realize it. The check for the $7,623 was issued with an incorrect address on it.

OIG Evaluation of Auditee Comments

a. HUD/FHA criteria requires Alliance to ensure that the borrower was competent to perform the rehabilitation work. It is apparent from the poor quality of work noted in our sample of loans that the borrower did not have the capacity to perform the

rehabilitation work. In our opinion, Alliance's quality control reviews should have identified the poor quality of work.

b. Regardless of whether the borrower performed the work or acted as a general contractor, any cash savings should not be paid to the borrower. Alliance is required to ensure that only the actual cost of rehabilitation work is paid.

c. Alliance is responsible to ensure that the rehabilitation specifications are properly prepared and the rehabilitation work is adequately completed. Alliance's quality control reviews neither verified the adequacy of the specifications nor the quality of rehabilitation work.

d. Alliance erroneously interpreted the contingency fund requirement. As explained at our exit conference, Alliance should have used the percentage of the mortgage amount to the appraised value as the criteria for releasing contingency funds.

e. While we were able to determine that the inspection fees had been deducted from the borrower's draw, the inspection fees were not shown on the accounting sheets. As a result, the accounting sheets did not accurately disclose all disbursements of the Section 203 (k) funds. Furthermore when Alliance provided us with a copy of the mislabeled check, we removed it from the Finding.

Recommendations

We recommend that you:

1A. Refer the conditions cited in this Finding to the Mortgagee Review Board for appropriate action.

1B. Consider reviewing the 40 other Section 203 (k) loans that are in default to determine if Alliance complied with all the applicable Section 203 (k)

requirements. Upon request, we will provide you the HUD/FHA case numbers of these loans.

In addition, we recommend that you require Alliance to:

1C. Implement procedures to ensure that borrowers who perform rehabilitation work are competent to perform such work.

1D. Implement procedures to ensure that only actual costs are paid from the rehabilitation escrow funds.

1E. Include in its quality control plan a requirement that its staff review the adequacy of the rehabilitation specifications and completed rehabilitation work.

1F. Implement procedures that will ensure the release of contingency funds to the borrower only if the situation meets the Section 203 (k) criteria.

1G. Implement procedures to ensure that the rehabilitation escrow funds are reconciled to the accounting sheets.

1H. Ensure that its staff are properly trained and thoroughly familiar with the Section 203 (k) loan requirements.

Alliance Did Not Underwrite Loans According to HUD/FHA Requirements

Alliance did not comply with HUD/FHA requirements pertaining to the underwriting of Section 203(k) loans. Our review disclosed that Alliance underwrote at least 12 of the loans in our sample of 22 loans that were made to one borrower, without ensuring that the borrower had sufficient funds to close the loans. In this regard, our review disclosed that a borrower used rehabilitation funds from other Section 203 (k) loans to actually close at least nine of these loans. This occurred because Alliance's staff did not ensure that the loans were processed in accordance with all of the HUD/FHA requirements. Because HUD/FHA relied on Alliance's underwriting process, Alliance caused HUD/FHA to incur an unnecessary risk by insuring these loans. At the completion of our field work all 12 loans, with mortgage amounts totaling $590,150, were in default.

Criteria

Title 24 of the Code of Federal Regulations, Part 203.5(c) provides in effect that a direct endorsement mortgagee shall exercise the same level of care that it exercises as if the mortgage was not being insured by HUD/FHA.

In addition to the above, Section 2-1 of HUD Handbook 4000.4 REV-1, Single Family Direct Endorsement Program, requires mortgagees to conduct its business operations according to accepted sound lending practices, ethics and standards. Paragraph 4-1 of Handbook 4240.4, Section 203 (k), Rehabilitation Home Mortgage Insurance, provides that the borrower must have sufficient assets to close the loan and that the mortgagee's mortgage credit analysis should be completed as prescribed in HUD Handbook 4155.1, Mortgage Credit Analysis for Mortgages for One to Four Family Properties. Paragraph 2-10 of this Handbook requires that the mortgagee (Alliance) verify the availability of the funds needed at closing.

Alliance used rehabilitation funds from other Section 203 (k) loans to close Section 203 (k) loans

Availability of Closing Funds

For 13 loans in our sample, Alliance recorded $27,000 as the borrower's available funds to close the loan on each of its mortgage credit analysis worksheet (worksheet). However, our review disclosed that Alliance only verified

the availability of the funds ($27,000) for one of the loans (372-2615054). We concluded that Alliance used the same $27,000 as the funds available to close all 13 loans when the borrower needed at least $107,731.22 (column 2 in chart below) to close all 13 loans. In short, Alliance did not verify that the borrower had sufficient funds to close the other 12 loans.

Our review disclosed that Alliance allowed the borrower to use Section 203 (k) rehabilitation funds from other loans to pay the closing costs for some loans in our sample. As shown below (Column 6), for nine of the 12 cases that Alliance did not verify the available of closing funds, we found that the closing funds came from the rehabilitation escrow accounts of other Section 203 (k) loans.

Column 1 HUD/FHA CASE NUMBER	Column 2 FUNDS NEEDED TO CLOSE	Column 3 FUNDS AVAILABLE	Column 4 DATE OF WORKSHEET	Column 5 DATE FUNDS VERIFIED	Column 6 203(K) REHABILITAITON FUNDS FROM OTHER PROPERTIES USED TO CLOSE LOAN
372-2599421	$177.47	$27,000	11/07/96		$4,361.00
372-2615054	$11,500.23	$27,000	08/30/96	08/23/96	
372-2618957	$9,916.09	$27,000	undated		$8,612.10
372-2643793	$11,293.99	$27,000	11/06/96		
372-2644231	$11,200.47	$27,000	11/11/96		$7,533.00
372-2644248	$2,689.37	$27,000	11/11/96		$10,294.01
372-2644260	$6,830.65	$27,000	11/11/96		$8,476.20
372-2644304	$1,453.26	$27,000	05/20/97		$7,686.18
372-2644342	$13,299.44	$27,000	11/08/96		$9,488.00
372-2645923	$2,453.77	$27,000	11/11/96		$8,717.00
372-2647057	$16,601.40	$27,000	02/10/97		
372-2647123	$11,075.76	$27,000	12/19/96		$2,904.00
372-2647136	$9,239.32	$27,000	12/06/96		
Totals	$107,731.22				$68,071.49

We believe that the borrower was able to do this because the borrower in some instances provided a cheaper quality of material than that required by the rehabilitation specifications and in other instances work was simply not completed, as discussed in Finding 1. For example, in one case we found that a lesser quality of vinyl tiles installed which probably resulted in a cheaper tile than the one stipulated in the rehabilitation specifications. In another situation, the rehabilitation specifications required that four heaters be installed; however, our inspection identified that only two were installed.

Alliance did not consider the borrower's weak financial position when originating Section 203(k) loans

Weak Financial Position

In addition to the lack of adequate funds to close the loans, Alliance allowed loans to be closed after becoming aware that the borrower was experiencing financial difficulties. On October 29, 1996, HUD/FHA issued Mortgagee Letter 96-59, Moratorium on the Investor Loans Mortgage Insurance Program, which placed a moratorium on Section 203(k) investor loans (the borrower is an investor). No new sales contracts were to be executed 10 days after the issuance of this Mortgagee Letter.

To meet this deadline the borrower quickly signed sales contracts for ten of our sample loans and requested HUD/FHA insurance through Alliance. However, the borrower was unable to close on the properties within the required 60 days and had to pay extension fees at a cost of $20 per day amounting to $12,460. During the review we learned that the borrower incurred the extension fees, because the borrower did not have the funds to close within the 60 day requirement. Alliance personnel told us that they were aware of closing delays and the delays occurred because the borrower did not have adequate funds to close the loans. Also, Alliance's personnel were aware of other credit problems of the borrower, as noted by a letter dated March 21, 1997, from the borrower to Alliance whereby the borrower attempted to explain some credit problems. We believe that a prudent lender once becoming aware of these financial problems, would have taken action to ensure that the borrower had the financial capacity to close on the loans.

We believe these deficiencies occurred because Alliance personnel did not ensure that the loans were processed in accordance with all of the HUD/FHA requirements. Also, we believe that Alliance neither acted as a prudent lender, nor exercised due diligence when underwriting these loans because it did not ensure that the borrower had the financial capacity to close the loans. As a result, HUD/FHA incurred an unnecessary risk insuring these loans. As of the completion of our field work, all 12 loans mentioned above with mortgage amounts totaling $590,150 were in default.

Auditee Comments

Alliance's officials stated that at the time of the applications, the borrower had approximately $ 27,000 in the First National Bank. This balance fluctuated greatly on a day-to-day basis. Alliance established a base file and when the borrower purchased another property, Alliance amended the file for the property address, the sales price, and prepared a good faith estimate based upon an unknown mortgage amount.

In addition, at any given time the borrower could have shown sufficient funds in the bank to consummate the transactions; however, due to the volume of the activity and HUD's requirements regarding verifying sources of funds, it sometimes seemed clearer to show copies of the (Section 203 (k)) draw checks as proof of funds to close the loan. Since the borrower was, in fact, the contractor and we had obtained the required certifications from the borrower certifying that there were no parties unpaid for the (Section 203 (k)) draw, we saw no reason that the borrower couldn't use draw funds for any purpose that the borrower chose. Alliance used the Section 203 (k) draw check as evidence of source of funds for the borrower to show sufficient funds to close.

Concerning the borrowers financial position, Alliance official said that the borrower had documented that the borrower had adequate funds at the time of the loan origination. However, after the specification of repairs were written, the underwriters determined that the borrower would require additional funds to close the loans. HUD and

the borrower mutually agreed to continue to apply for and approve extensions of the HUD contracts. Alliance did not interpret this to mean that the borrower was in financial distress. Also, all mortgage payments were current and we did not believe that minor late payments on student loans or credit cards to be a significant forecast of impending financial collapse. Furthermore, it is our understanding that the collapse of the borrower's real estate enterprise was due to the illness and death of the borrower's parents, a change in the borrower's management staff and drastic changes enacted by the City of Rochester, New York that has severely impacted the profitability of investment property.

OIG Evaluation of Auditee Comments

The borrower used the same $27,000 as the assets available to close numerous loans. Since Alliance's mortgage credit analysis worksheets were dated at various times over a period in excess of eight months, it is apparent that the information was not accurate. In fact, the borrower needed at least $107,731.22 to close all 13 loans mentioned in the Finding. Our review disclosed that for nine loans, the closing funds were provided from the rehabilitation escrow accounts of other Section 203(k) loans. Since the borrower was performing the rehabilitation work, the borrower's certification that there was no unpaid parties regarding the other Section 203 (k) loans was meaningless.

Regarding the borrower's weakened financial position, our concern is not with how the extensions where granted but the reasons that the borrower requested the extensions, i.e., a lack of funds available to close the loan. Alliance was aware of this reason. We believe that a prudent lender, once becoming aware of a borrower's financial difficulties to close loans, would take actions to ensure that the borrower had the financial capacity to close loans.

Recommendation

We recommend that:

2A. In conjunction with the deficiencies noted in Finding 1 and in this Finding, you take the

appropriate administrative sanction against the Rochester Branch of Alliance Mortgage Banking Corp.

Management Controls

In planning and performing our audit, we obtained an understanding of the management controls that were relevant to our audit. Management is responsible for establishing effective management controls. Management controls, in the broadest sense, include the plan of organization, methods and procedures adopted by management to ensure 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.

Relevant Management Controls

We determined the following management controls were relevant to our audit objective:

- Program operations - Policies and procedure to ensure that section 203 (k) loans were originated and closed in accordance with all HUD/FHA regulations.
- Validity and Reliability of Data - Administrative controls to ensure the validity and reliability of Section 203 (k) loan documents and accounting records.
- Compliance with Laws and Regulations - Policies and procedure Alliance implemented to ensure that the investor/borrower complied with the terms and conditions of HUD/FHA regulations.
- Safeguarding Resources - Policies and procedure that Alliance implemented to reasonably ensure that resources for the Section 203(k) rehabilitation escrow funds are safeguarded against waste, loss and misuse.

We assessed all of the relevant control identified above.

Significant Weaknesses

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 that significant weaknesses exist in the following management controls. These weaknesses are described in the Findings section of this report. In summary, we found that:

- Alliance did not develop adequate procedures regarding origination and closing of HUD/FHA Section 203 (k) loans, Finding 2 (Program Operations).

- Alliance did not implement an adequate quality control plan, Finding 1 (Compliance with Laws and Regulations).

- Alliance did not maintain adequate accounting records for rehabilitation escrow funds, Finding 1 (Validity and Reliability of Data).

- Alliance did not implement adequate policies and procedure to reasonably ensure that resources regarding the Section 203 (k) rehabilitation funds are safeguarded against waste, loss and misuse. As result, Section 203 (k) funds were disbursed for work either not completed or not performed in a workmanlike manner, Finding 1 (Safeguarding Resources).

Follow Up On Prior Audits

This was the first Office of Inspector General (OIG) audit of Alliance Mortgage Banking Corp., Rochester Branch Office, Rochester, New York. Alliance's independent audit report for the year ended June 30, 1997, did not contain any Findings related to Alliance's Rochester Branch Office, Rochester, New York.

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Auditee Comments

Finding One

Alliance did not ensure that the borrower was competent to perform rehabilitation work.

The borrower was competent to perform the work. Alliance Mortgage Banking Corp. was approved to direct endorse 203k loans on August 3lst 1993. At that time, however, direct endorsement approval was applicable only to the mortgage credit portion of the approval process. FHA retained to plan review and appraisal portion of underwriting duties for an additional year or so.

During the time frame of 1989 to 1995, FHA oversaw and approved the work write-ups, the appraisal, the inspections and all accounting procedures. During this entire time, which occurred after the provisions of handbook 4240.4 rev-2 and mortgagee letter 94-1l, FHA permitted the borrower to act as her own general contractor. Naturally, after having worked with the borrowers for a number of years, and having been trained by the staff at the Buffalo HUD office, as well as having attended numerous FHA training sessions conducted by a training consultant and associates, we continued performing our duties as we were directed to by our insuring office and the training consultant.

We did not conduct a formal approval of the borrower, as we were aware of her qualifications and experience and had first hand knowledge of the renovations that she had successfully completed. In support of our determination, we are enclosing a letter of qualification from the borrower, together with a copy of her business renovation company license, and a copy of the phone book listing forte licensed company.. Copies of rent checks forte office space leased by her renovation company is available if required.

In summary, we felt that there was no reason to conduct a formal approval of the borrower as her own general contractor. Inasmuch as she was found to be acceptable to the approval and insuring offices of the Federal Housing Administration, and since she demonstrated her ability to complete renovations in accordance with their regulations and requirements, we found her acceptable for our DE purposes. A lack of formal approval, however, does not indicate that we did not find the borrower competent to act as her own GC in performing the work.

Although there is a signature bar for the contractor's signature, since the borrower and contractor were the same person, no additional signature was obtained.

Alliance did not establish procedures to ensure that the borrower was only reimbursed for the actual cost of the rehabilitation work.

If the contractor/borrower and consultant indicated that this was the cost of the renovation, and the inspector advised us to release a certain amount to the borrower, which was what we did. There had been no provisions prohibiting the contractor from making a profit on the rehabilitation end. We are sure that this had been addressed with the training consultant and at that time it was not a problem.

The regulations governing the 203k program have been expanded significantly in the past five years. Prior to that time there were really very few experts on the program and the training, procedures and requirements provided to the few lenders making these mortgage loans was minimal at best. The standards that we were held to in 1995, 1996 and 1997 are certainly different that those that have been in place since mortgage letter 98-11.

Alliance needs to strengthen controls over the rehabilitation repairs.

In 1996, when these files were originated, We called for additional inspections to ensure that the properties were complete, safe and habitable, such as:

1. Third party certifications for plumbing, heating and electrical work, and
2. Certificates of Occupancy.

Additionally, the consultant selected by the borrower (only one of four that had been approved by the Buffalo Office at that time) was also an engineer. He was believed to be an extremely competent individual who was not known for giving any breaks. In fact, he was one of the very few approved to be consultants, plan reviewers and new construction inspectors. His certification that the work had been completed, together with the additional third party inspections, satisfied us that the work had been completed as reported and certified to.

The majority of the properties are located in very troubled areas. It was not uncommon for the borrower to have to complete the repairs more than one time. In fact, there were many instances where the work that was acceptably completed in draw one had to be redone by the final draw or the inspector would not release the final and holdbacks. We are not surprised that you have encountered instances where the work does not appear to have been performed. All of our inspections and experience with the borrower demonstrated that she completed the repairs as required.

Some of the properties cited as deficient were also inspected by HUD for section 8 rentals and approved. See copy of rent voucher from section 8 attached.

After issuance of mortgagee letter 98-1l, we did realize the need for greater control as the program expanded and the requirements became more stringent. Please see our notice to inspectors and consultants requiring before and after photos, together with photos at each and every draw. Contractor lien waivers, receipts, canceled checks and check requests are also now required.

Inadequate accounting controls of rehabilitation funds.

As indicated, there were 10 loans that were cited for accounting irregularities. Eight of these were not accounting errors. The consultant and borrower indicated that the repairs would be done in a certain number of draws. We escrowed inspection fees for exactly the number of draws indicated. The borrower did not complete the repairs within the specified number of draws. The additional inspection fee was deducted from the draw moneys. It seemed uncomplicated to us that if the borrower had 5 inspection and there were only two inspections escrowed for, then the remaining inspections would be deducted from the repair escrow. This was shown on our computer check records, and was listed on the draw request sheet, and the sheet to the investor from whom we requested the money, but was not set out on the accounting overview sheet, as there is no place to show it.

There was a transposition error of $180.00, which we did not realize, nor did the borrower or investor.

There was not a problem with the accounting sheet for the draw in the amount of $7623.00. A copy of the check corresponding to the draw is attached. The checks are drawn on computer. The computer recognizes the name and completes the check as an exact duplicate of the last check draw. When the check was prepared the memo section was not amended to show the correct property address, thus the examiner thought that the accounting sheet was in error.

Finding 2

Alliance used rehabilitation funds from other section 203k loans to close new Section 203k loans.

At the time of application, the applicant had approximately $ 27,000.00 in First National Bank. Due to the extent of her enterprises this balance fluctuated greatly on a day-to-day basis. That happened to be the amount that had previously been verified by the processors. Due to the sheer volume of paperwork, approximately one and one-quarter reams of paper per application, we established a base file which was maintained in our computer processing system. When the borrower purchased another piece of property, whether from HUD, the city, a foreclosure or in a more traditional manner, we simply copied the file and amended the property address, the sales price, prepared a good faith estimate (which was really worthless as the specification of repairs and appraisals wouldn't be available for at least another month or so) based upon an unknown mortgage amount, and the required truth-in-lending, Reg. Z.

In purchasing a HUD property disposition case, it was required that the borrower put down a down payment of 15% of the purchase price alone. All other costs including the entire rehabilitation, etc. were available to be financed. Therefore, at the time of application the borrower showed sufficient fund to close. It wasn't until further on in the process, after examination of the appraised values and evaluation by the underwriter that it was determined that a greater down payment was required.

After discussions with the borrower and the property disposition section of our local FHA office in Buffalo, we were advised that HUD would continue to extend the contracts of sale, as they found it to be in their best interest to do so. Please see a letter to this effect, attached hereto, signed by the deputy director.

At any given time, the borrower could have shown sufficient funds in the bank to consummate the transactions, however due the volume of activity, and HUD's requirements concerning verifying the source of funds in the accounts, it sometimes seemed clearer to show copies of the draw checks as proof of funds to close. Since the borrower was, in fact, the contractor and we had obtained the required certifications from the borrower (see certification attached) certifying that there were no parties unpaid for the draw, we saw no reason that the borrower couldn't use the replenished funds for any purpose that she chose. In this case it was to purchase an additional HUD house.

At no time did Alliance use 203k funds to close any loan. We used the 203k draw check as evidence of the source of funds for the borrower to show sufficient funds to close.

Affiance did not consider the borrowers weakened financial position when originating section 203k loans.

As outlined earlier, the borrower of a PD sale was required (at that time) to put down 15% of the sales price only (for an investor loan). The borrower had documented adequate funds at the time of origination to consummate the transactions. However the specification of repairs, after improved appraised value of the properties and the determination of the underwriters, revealed that the borrowers would require additional funds to close.

These circumstances were related to the PD division of our local HUD office and the borrower. They mutually agreed to continue to apply for and approve extensions of the HUD contracts. We did not interpret this to mean that the borrower was in financial distress.

The letter of March $_{21st}$ to the borrower was in response to another updating of the borrower's credit package, which we required every 90 days. The last credit report revealed minor credit

glitches, which required explanations. All mortgage payments were current and with twenty odd pages of credit reporting, we did not feel those minor late payments on student loans or credit cards to be a significant forecast of impending financial collapse. These minor credit glitches had been consistent throughout the years and we did not find them to be a source for declination.

Please see a letter from her Certified Public Account, attached hereto, as to his understanding of her financial condition during the time period referenced.

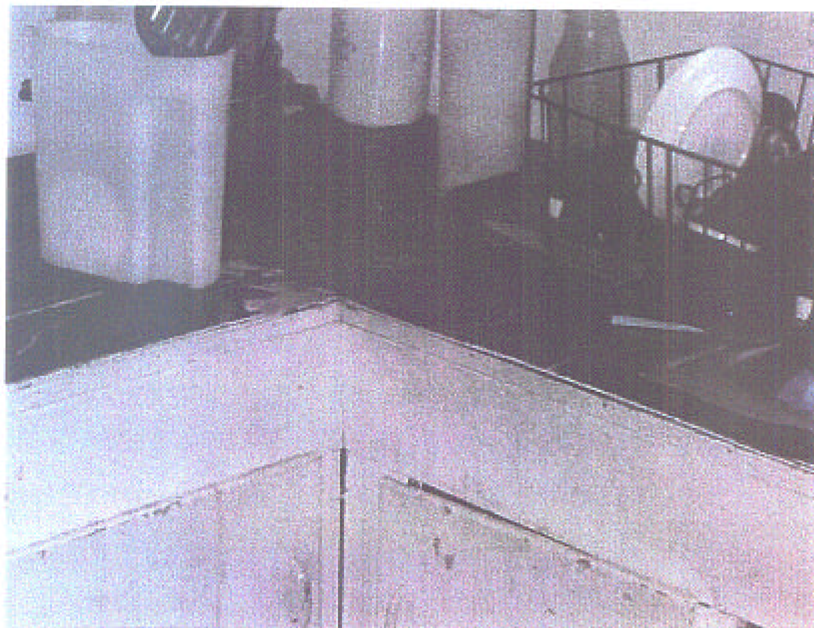
Furthermore, it is our understanding that the collapse of her real estate enterprise was due to the severe illness of her parents and their ensuing deaths, a change in her management staff and drastic changes enacted by the city of Rochester which has severely impacted the profitability of investment property in the City of Rochester. The landlords association will be initiating a letter writing campaign within the next two weeks. We anticipate receiving between one hundred to one hundred fifty letters substantiating the difficulties the landlords have experienced in the City of Rochester, specifically the removal of many properties from the voucher system whereby payments that were being made directly to the landlord were now being made payable to the tenant.

We removed the name of the borrower and the training consultant in Alliance's response. Also, attachments provided by Alliance are not included as part of this Appendix.

Pictures

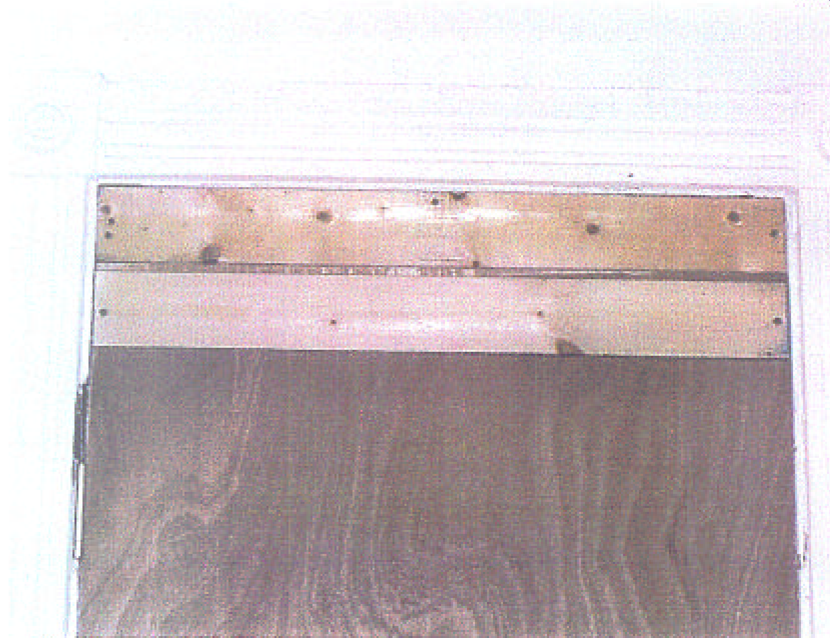
FHA Case 372-2618957. The specification for rehabilitation work items required new roofing which was not installed.

FHA Case 372-2644260. The specification for rehabilitation work items required the contractor to scrape, sand smooth, and paint a minimum 2 coats of good quality paint at a lump sum amount of $3,420



FHA Case 372-2597160. The following were not completed or were not completed in a workmanlike manner. Kitchen countertop installed for $275, repair and paint enamel on cabinets $275, and rebuild kitchen base cabinet $340.

FHA Case 372-2655733. The specification for rehabilitation work items required new roofing throughout entire house for $4,000. We found portions of the roof that were not completed.



FHA Case 372-2597160. The exterior door was installed for $364. However, the door did not fit properly into the frame.

FHA Case 372-2618957. The exterior door was installed for $364. But, the door did not fit the span. So, the contractor placed a 2X4 below the header without insulating and trimming the new header. This created an aesthetically inferior product not to mention a security risk.

Appendix B

FHA Case 372-2647057. The specification for rehabilitation work items required 798 square feet to paint porch ceilings and deck at $1,185. The work was not done in a professional workmanlike manner.

FHA Case 372-2594476. The specification for rehabilitation work items required the removal of an existing front fence. The work item was not completed.

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