TO: Bernice Campbell, Director, Single Family Housing, 9EHS

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

SUBJECT: Monitoring of the Real Estate Asset Management Contract
Real Estate Owned Branch
Phoenix Office

INTRODUCTION

We recently conducted a review of the sale of Real Estate Owned (REO) properties by the HUD Phoenix office. During this review we became aware of problems affecting HUD's administration of its real asset management contract with Real Estate Asset Management, Inc. (contractor). We expanded our review, on a limited basis, to address these concerns. This memorandum contains the results of our review of HUD's monitoring of the contract.

SUMMARY

REO staff did not effectively monitor the REAM contractor's performance. As a result, areas of contractor noncompliance were not identified and corrected, resulting in (1) HUD payment of at least $3,960 for work not performed and (2) FHA insurance on properties with MPS violations and/or health and safety hazards. The inadequate monitoring occurred because REO staff did not follow Handbook guidelines for monitoring REAM performance and they were unfamiliar with REAM contract performance requirements. We are recommending that REO's monitoring process be strengthened, that realty specialists receive training, and that all proposed contract changes and areas of major contract noncompliance be directed to the HUD Contracting Officer. Further, the contractor should be required to (1) correct noted deficiencies, including completion of repairs to properties we inspected where HUD paid for repairs which were not performed; (2) certify to HUD that repairs to other properties still in inventory, for which HUD has paid, have been made; and (3) repay HUD for any repairs not made. Dependent on corrective actions taken by the contractor, you should consider administrative sanctions. In addition, you should evaluate and consider the contractor's performance when awarding the next REAM contract.

BACKGROUND

HUD contracted with Real Estate Asset Management, Inc. (contractor) on July 18, 1994 for management services on all single family acquired properties in the Phoenix area. Services to be provided include weekly property inspections, identification and correction of all MPS violations and health and safety hazards, and other repairs as approved by REO. Services may be subcontracted at the contractor's discretion. The contract will expire October 31, 1997.

Instructions for performance and examples of minimum property standards and health and safety hazards are detailed in the contract. Guidelines for HUD monitoring of contract performance are given in the Property Disposition Handbook 4310.5 Rev-2, Chapter 12.

PURPOSE AND METHODOLOGY
The objectives of this limited review were to determine if HUD was effectively monitoring the REAM contract and whether the contractor was complying with the contract. To accomplish these objectives we:

- Interviewed REO staff concerning inspection procedures and reviewed the 1995 and 1996 annual REO field reviews of the contractor.
- Reviewed the REAM contract and modifications, Chapter 12 of the Property Disposition Handbook, applicable Arizona Revised Statutes, and Rules of the Registrar of Contractors.
- Identified unofficial contract changes and interviewed the HUD Contracting Officer concerning the validity of these changes.
- Interviewed eleven HUD homebuyers about the condition of their properties at the time they obtained ownership. We reviewed the corresponding REO case files and contractor property files and made site visits to eight of the eleven properties.
- Reviewed nine subcontractor files. We obtained current contractor license status on the nine subcontractors from the Arizona Registrar of Contractors.
- Obtained Form 1099’s for the nine subcontractors from the contractor and REO, and printouts of HUD’s latest payments to these subcontractors.
- Made site visits to seven REO properties still in inventory.


**REVIEW RESULTS**

**REO STAFF DID NOT EFFECTIVELY MONITOR THE REAM’S PERFORMANCE.**

REO staff did not effectively monitor the REAM contractor's performance. As a result, areas of contractor noncompliance were not identified and corrected, resulting in (1) HUD payment of at least $3960 for work not performed and (2) FHA insurance on properties with MPS violations and/or health and safety hazards. The inadequate monitoring occurred because REO staff did not follow Handbook guidelines for monitoring REAM performance and they were unfamiliar with REAM contract performance requirements.

Property Disposition Handbook 4310.5 Rev-2, Chapter 12 provides the minimum procedures for monitoring the REAM contractor’s performance. The contract provides descriptions of REAM performance requirements, including MPS violations and health and safety hazards to be eliminated.

Specific problems noted during our review and discussed below were:

a. REO staff did not make routine inspections of acquired properties as required.

b. Reviews of the contractor's operations were not adequate.

c. Reviews were not made to ensure that subcontractors were properly licensed and insured.

d. Contract performance requirements were changed without the contracting officer’s authorization.
a. **REO staff did not make routine inspections of acquired properties.**

REO staff did not follow Handbook requirements for making property inspections. The Handbook requires realty specialists to review and inspect properties as often as necessary to ensure that all aspects of REAM contract performance comply with REO program objectives. Additionally, the handbook states that monthly site inspections in each stage of processing should be made of 10 percent of the properties increasing as necessary, up to 100 percent, when performance is unsatisfactory. Contrary to these requirements, property site visits were not routinely made by all realty specialists. In fact, most realty specialists were not making any property site visits.

Further, when inspections were made, REO staff had incomplete information available to make inspections of subcontracted repair work. REO staff stated that they attempt to compare work orders and additional repair authorizations with actual work performed at the properties.

However, we found work orders and additional repair authorizations in the contractor's files that were not in the corresponding REO files. We were also informed that REO decided not to require the contractor to submit additional repair authorizations for review and approval (see contract performance requirements discussed below in item d). As a result, REO staff lacked information needed to identify claimed work and determine whether it was actually completed by the subcontractors.

Additionally, while some deficiencies in the contractor's performance may have been detected by REO staff, there were no procedures for reporting these deficiencies to the Contracting Officer and other responsible officials for appropriate action. As discussed below, this resulted in HUD's paying for work not performed and the insurance of properties with MPS violations and/or health and safety hazards.

- **HUD was billed and paid for work not performed**

At fourteen of eighteen properties we surveyed, we found that HUD was billed and had paid for REAM subcontracted repair work not performed. Some homebuyers gave us invoices showing they had paid for these claimed repairs upon move-in. In other cases, we visited the homes and noted that repairs for which the subcontractors were paid had not been done. The most common repairs billed for but not performed were removal of defective paint, plumbing repairs, and roof repairs. The fourteen properties with work billed and paid for, but not performed, are detailed in Attachment 1. HUD paid $3,960 for these repairs.

- **Homes were insured with MPS violations and/or health and safety violations**

Four properties reviewed were insured with minimum property standard violations, as defined in the REAM contract and HUD regulations. Three of the homes were insured with bare concrete flooring. In all three cases, the contractor's inspectors recommended the homes be sold insured with a repair escrow to include a new carpet. However, REO realty specialists failed to list the properties with repair escrows to provide the needed flooring.

Another home was sold in May 1996 with an unsanitary carpet, a roof with no remaining useful life, and a bedroom wall covered with mold. REO failed to act on these deficiencies when reported by a previous bid winner who canceled the sales contract due to the defects. The property was relisted as insurable with no repair escrow although the home did not meet MPS...
requirements. REO did not visit the property or ask the contractor why these conditions were not reported and corrected.

According to the contractor, the roof had at least a two year remaining useful life. The contractor did not clean or remove the carpet as required by the contract. Although the moldy wall had initially been covered by wallpaper, eight inspections made by the contractor after the wall was uncovered did not note the wall's condition. These conditions are listed in the contract as conditions which must be corrected prior to an insurable sale. On February 11, 1997, at the request of the HUD Contracting Officer, the contractor inspected the property and determined the roof was only in need of minor repairs, the carpet was sanitary, and the moldy wall had been sealed. However, on March 12, 1997, the HUD Contracting Officer and a licensed roofing inspector inspected the property as a result of our concerns and found the roof had **no useful remaining life and needed to be replaced**, the carpet needed to be removed, and the moldy wall needed to be cleaned and painted. These conditions still existed as of June 1997. HUD is currently in the process of contracting for these repairs.

Six homes in our sample were insured with health and safety hazards, as defined by the contract and HUD regulations. One home was insured with an upstairs deck and rail which were rotted. The contractor also billed for scraping defective paint in the areas where the wood was rotted. When the homebuyer moved in, there was peeling and flaking paint and the deck had to be completely replaced by the Home Owners' Association. At least five other homes were sold with defective paint surfaces.

We believe many of the contract performance deficiencies identified in our limited review could have been found by REO staff had they made regular property inspections. During site visits to properties in inventory on February 7, 1997 we found that many of the same performance deficiencies, including billing for work not performed and failure to correct health and safety hazards, still existed.

**b. Review of the contractor's operations were not adequate.**

The REAM contract was assessed by REO as low-risk based on 1995 and 1996 field reviews. Handbook 4310.5 Rev-2 states that semi-annual reviews must be made on a low-risk contract; however, visits to the contractor's office were made only once a year.

Additionally, our analysis of documentation supporting REO's reviews showed that the reviews were inadequate and that insufficient documentation was obtained to support REO's low risk determination. In fact, during the reviews REO documented problems with the contractor's performance which should have been resolved prior to risk determination. For example:

- REO's 1995 review of closed cases showed that for nine of the ten cases reviewed, either the contractor did not have documentation available to support its adherence to contract requirements or REO failed to resolve questions raised by its own review. Accordingly, REO did not have sufficient information to rate the contractor's performance.

- REO's 1996 review disclosed that for 12 of the 27 active cases reviewed, the contractor was not making timely inspections of repairs. In relation to closed cases reviewed, 13 of the 16 files reviewed did not contain property sign-in sheets. Accordingly, REO could not determine whether required weekly inspections of properties were being made.
REO failed to inspect inventory properties as part of the contractor reviews. During these reviews, the realty specialists reviewed randomly-selected files for certain documents. However, many of the questions asked to assess risk can only be answered by visiting the sample properties - which was not done. For example, one question to be answered states: "Are properties being maintained in accordance with the contract?" This question was answered "yes" in both years even though none of the sample properties were inspected. In our opinion, identifying physical problems with a property, if any, and verifying whether claimed work was actually performed is more important than determining whether a document is in a file.

Had REO performed adequate contract reviews, including inspections of selected properties, many of the problems we found during our review such as billing for work not performed and insurance of properties with existing health and safety hazards and MPS violations, may have been identified and corrective action could have been taken.

c. Reviews were not made to ensure that subcontractors were properly licensed and insured.

REO did not review subcontractor files as part of their field reviews, or review subcontractor information submitted to HUD to be entered into Single Family Acquired Asset Management System (SAAMS). As a result, they did not detect unlicensed and uninsured subcontractors.

Eight of the nine subcontractors we reviewed were not properly licensed for the type of repairs they were performing. Seven of these contractors were still performing HUD repairs as of February 5, 1997. We noted that only one of the nine contractors was properly licensed to perform plumbing repairs; four contractors were licensed in other fields and, as such, were required to subcontract plumbing services; and the remaining four contractors were prohibited from performing any repairs. Three of these contractors have never been licensed in Arizona. The fourth had a suspended plumbing license.

The REAM contract requires the contractor to obtain "any necessary licenses and for complying with any Federal, State, and municipal laws, codes, and regulations applicable to the performance of the work." Plumbing licenses are specifically required by the contract, which states that a plumbing service call must be made by a "licensed contractor that specializes in water and sewer repair."

Additionally, four of the nine subcontractor files reviewed contained no proof that the subcontractors had contractor's licenses, privilege tax licenses, general liability insurance, or Workers' Compensation Insurance, all required by the contract.

We noted that many of the contractors were also violating both the Arizona Revised Statutes and Arizona Registrar of Contractors Rules. For example, three contractors were performing plumbing repairs which were explicitly disallowed by their license classifications. An unlicensed contractor was falsely representing himself to be a licensed contractor and a licensed contractor illegally allowed her license to be used by this and another unlicensed contractor.

d. Contract performance requirements were changed without the contracting officer's authorization.

Contractor and REO staff informed us of several verbal and written contract modifications. However, the official modification process was not followed, nor were there any changes in
contract prices to correspond with these changes. Such unofficial changes are prohibited by the Handbook which states: "All contract modifications must be in writing and signed by an authorized contracting officer."

According to the contractor, several changes in the contract terms were made in the best interest of the Government and at the direction of REO staff. Some examples of these changes are:

- Repair inspections are not made within 48 hours as required by the contract. Rather, repairs are inspected on the next seven day inspection whether or not that date falls within the required 48 hour time frame.

- Additional Repair Authorizations, required by the contract for all non-emergency repairs made, were eliminated. As a result, not only does the contractor order additional repairs without REO knowledge and approval, but REO does not have copies of the work orders when property inspections are made. As a result, REO cannot monitor these repairs to ensure they are properly completed.

- For-Sale signs are posted after the first Tuesday bid offering when the property has not sold rather than when the property is first listed for sale.

The HUD Contracting Officer stated he did not, and will not, authorize these changes and others noted by the contractor because they are not in the best interest of the Government.

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We reported similar findings in OIG Audit Report No. 91-SF-123-0002, "Internal Audit Report on Area Management Brokers and Related Service Contractor Activities," issued March 22, 1991. We found the REO division, as noted in our current review, did not comply with Handbook guidelines for monitoring the asset management contract monitoring. That earlier report recommended REO staff be properly trained on how to monitor the contract.

We noted that the Acting REO Director during this time period had taken significant steps to improve the monitoring of the REAM contractor's performance. However, we believe additional steps are necessary in order to protect homebuyers and HUD from insuring homes with existing MPS violations and health and safety hazards, as well as, to put an immediate end to the practice of billing HUD for work not performed.

**RECOMMENDATIONS**

We recommend that you:

A. Establish written REO monitoring procedures, based on contract performance requirements and Handbook 4310.5 Rev-2 Chapter 12, to ensure that:

- effective property inspections are made (note: the Handbook requires a minimum of 10 percent of the properties to be inspected increasing, as necessary, up to 100 percent, when performance is unsatisfactory);

- frequency of monitoring visits to the contractor are commensurate with ratings assigned;
• HUD does not pay for work not performed;
• HUD does not provide FHA insurance on homes with existing MPS violations and health and safety hazards; and
• subcontractors are properly licensed and insured as required by the contract.

B. Train REO staff on asset management performance requirements of the contract and on how to identify areas of contract noncompliance, MPS violations, and health and safety hazards.

C. Provide written instructions requiring REO employees to cease making or accepting any verbal or written changes to the real estate asset management contract and to forward all proposed changes to the HUD Contracting Officer for consideration.

D. Establish written procedures for making referrals to the HUD Contracting Officer when instances of major contract noncompliance or routine noncompliance are found.

E. Inform the contractor of deficiencies in its current performance and ensure these deficiencies are corrected. In this regard, you should require the contractor to either complete the repairs shown in Attachment 1 or repay the $3,960 HUD paid for the repairs. In addition, you should require the contractor to review its files for all properties still in inventory and provide you, for each property, a certification that all repairs for which payment was received were completed or an explanation as to why such a certification could not be made. For any repairs not certified to, the contractor should be required to either complete the repairs or return the payments to HUD.

F. Dependent on corrective actions taken by the contractor under Recommendation E, you should consider whether administrative sanctions are appropriate and, if so, initiate such sanctions. In addition, you should evaluate and consider the contractor's performance when awarding the next REAM contract.

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Within 60 days, please furnish us a status report on the corrective action taken, the proposed corrective action and the date to be completed, or why action is not considered necessary for the recommendation. Also, please furnish us copies of correspondence or directives issued because of this review.

If you have any questions, please contact me at (415) 436-8101 or Senior Auditor Charles Johnson at (602) 379-4675.

Attachments: 1. Repairs Billed and Paid For But Not Performed 2. Distribution
Attachment 1
Distribution

Secretary's Representative, 9AS (2)
Director, Single Family Division, Phoenix Office, 9EH (2)
Chief, Single Family Real Estate Owned Branch, Phoenix Office, 9EHSR
State Coordinator, Phoenix Office, 9ES (2)
Director, Field Accounting Division, 9AFF
Director, Administrative Service Center 3, Denver, 9AAR
Director, ASC 3, Contracting Branch, Denver, 9AAC
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Chief Financial Officer, F (Room 10164) (2)
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Director, Housing Finance Analysis Division, REF (Room 8204)
Director, Office of Press Relations, WR (Room 10138)
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Mr. Pete Sessions, Government Reform and Oversight Committee,
Congress of the United States, House of Representatives,
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The Honorable Fred Thompson, Chairman, Committee on Governmental Affairs,
United States Senate, Washington, D.C. 20510-6250
The Honorable John Glenn, Ranking Member, Committee on Governmental Affairs,
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