Prudential Huntoon Paige Associates, LTD, Arlington, VA

Multifamily Accelerated Processing Program, Lafayette Towers Apartments (Detroit, MI)

Office of Audit, Region 4
Atlanta, GA

Audit Report Number: 2015-AT-1007
August 14, 2015

To:	Nancy-Ann Bodell, Acting Director, Office of Asset Management and Portfolio Oversight, HTN Dane Narode, Associate General Counsel for Enforcement, CACC Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB
	//signed//
From:	Nikita N. Irons, Regional Inspector General for Audit, Atlanta Region, 4AGA
Subject:	Prudential Huntoon Paige Associates, LTD, Did Not Underwrite and Process a $22 Million Loan in Accordance With HUD Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Prudential Huntoon Paige Associates' underwriting of a 223(f) refinance loan, Lafayette Towers Apartments.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 404-331-3369.

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Prudential Huntoon Paige Associates, LTD, Did Not Underwrite and Process a $22 Million Loan in Accordance With HUD Requirements

Highlights

What We Audited and Why

We audited Prudential Huntoon Paige Associates, LTD's underwriting of a $22.8 million mortgage loan to refinance Lafayette Towers Apartments, a 584-unit highrise multifamily project in Detroit, MI. We initiated the review based on the early default, assignment, and significant amount of the project. Our objective was to determine whether Prudential underwrote and processed the loan for Lafayette Towers according to the U.S. Department of Housing and Urban Development's (HUD) requirements.

What We Found

Prudential did not underwrite and process the refinance loan for Lafayette Towers in accordance with HUD's guidelines and regulations. Specifically, it did not ensure that the project capital needs assessment was complete and accurate, adequately assess the borrower's eligibility, adequately assess the property's financial capacity, and ensure that the appraisal report was supported. Prudential exposed the Federal Housing Administration (FHA) insurance fund to unnecessary risk and a loss of more than $15 million because it inappropriately submitted and concluded that the loan for Lafayette Towers was an economically sound and acceptable risk to HUD. Prudential recommended the project be refinanced for $22.8 million when the owner purchased the project for only $16 million less than a year before. The refinance only showed repairs of $1.4 million and allowed a $5 million equity take out for the owner.

What We Recommend

We recommend that the Director of the Detroit Office of Multifamily Housing Programs refer Prudential to the Mortgagee Review Board to take appropriate action for violations that caused a more than $15 million loss to HUD's FHA insurance fund or other administrative action as appropriate. We also recommend that HUD's Office of General Counsel for Program Enforcement pursue civil remedies, if legally sufficient, against responsible parties. Additionally, we recommend that the Departmental Enforcement Center pursue administrative actions, as appropriate, against the responsible party for the material underwriting deficiencies cited in this report.

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Background and Objective

Prudential Huntoon Paige Associates, LTD, is one of the Nation's leading originators of Federal Housing Administration (FHA) multifamily and health care loans with regional offices located throughout the United States. Prudential is a multifamily accelerated processing (MAP)-approved lender that underwrote and processed a 223(f) refinance loan for Lafayette Towers Apartments in Detroit, MI, which consists of 584 units.

Section 223(f) of the National Housing Act authorizes loans to be insured by FHA to facilitate the purchase or refinancing of existing multifamily rental housing. Section 223(f) insures lenders against loss on mortgage defaults. The program allows for long-term mortgages (up to 35 years) that can be financed with Government National Mortgage Association mortgage-backed securities. This eligibility for purchase in the secondary mortgage market improves the availability of loan funds and permits more favorable interest rates. These multifamily projects may have been financed originally with conventional or FHA-insured mortgages. Properties requiring substantial rehabilitation are not eligible for mortgage insurance under this program. The U.S. Department of Housing and Urban Development (HUD) requires completion of critical repairs before endorsement of the mortgage and permits the completion of noncritical repairs after the endorsement for mortgage insurance.

By insuring mortgages, HUD encourages private lenders to enter the housing market to provide financing that otherwise might not be available to owners. Under HUD's MAP program, approved lenders prepare, process, review, and submit loan applications for multifamily mortgage insurance. In accordance with MAP guidelines, the sponsor works with the MAP-approved lender, which submits required exhibits for the preapplication stage. After HUD reviews the exhibits, it either invites the lender to apply for a firm commitment for mortgage insurance or declines the application. For acceptable exhibits, the lender submits the firm commitment application, including a full underwriting package, to HUD to determine whether the loan is an acceptable risk. MAP Guide, Revised 2002, requires that lenders provide a narrative analysis within the firm commitment application, describing the mortgage transaction containing a discussion of the characteristics of the proposed loan that make it economically sound or an acceptable risk. If HUD determines that the project meets program requirements, it issues a firm commitment to the lender for mortgage insurance.

In accordance with MAP guidelines and Federal regulations, Prudential is responsible for reviewing all documents submitted to HUD for insurance. Lafayette Towers' loan was closed and endorsed on August 20, 2009, with a mortgage amount of $22.8 million. The mortgage amount also included a $5 million equity take out, which was disbursed to the borrower at closing. The borrower was not required to use the equity take out for project purposes. The project's first notice of default was in June 2010. It was assigned to HUD in April 2011, and HUD paid a claim of more than $21.5 million on August 22, 2011. The property was sold to the City of Detroit for $5.8 million on November 5, 2012, which resulted in a loss of more than $15 million.

HUD’s Office of Multifamily Housing Programs is responsible for the overall management, development, direction, and administration of HUD’s multifamily housing programs. The Office of Multifamily Housing Development provides direction and oversight for FHA mortgage insurance loan origination, including the implementation of the MAP program.
HUD’s Office of Multifamily Housing Programs required Prudential to obtain a project default review of Lafayette Towers from a third-party source. Its purpose was to determine what caused the early default and whether the MAP lender complied with program requirements. Prudential hired a third-party contractor, which reviewed the loan documents and submitted its report on January 9, 2014. However, our audit was separate from this review.

Our objective was to determine whether Prudential underwrote and processed the loan for Lafayette Towers according to HUD’s requirements.

Results of Audit

Finding: Prudential Did Not Underwrite and Process a $22 Million Loan in Accordance With HUD Requirements

Prudential did not underwrite and process the FHA-insured mortgage loan for Lafayette Towers in accordance with HUD's guidelines and regulations. We identified several underwriting deficiencies related to (1) the project capital needs assessment, (2) the borrower's eligibility, (3) the property's financial capacity, and (4) the property's appraisal. This condition was caused by Prudential's failure to conduct due diligence, practice prudent underwriting, and conduct a sufficient review of related documents and third-party reports, which HUD relied on. As a result, Prudential exposed the FHA insurance fund to unnecessary risk and a loss of more than $15 million.

Prudential Did Not Perform an Adequate Review of the Project Capital Needs Assessment

Prudential did not ensure that the project capital needs assessment used during underwriting was complete and accurate. MAP Guide, Revised 2002, chapter 5-25(A) and (B) provides that lenders are required to provide HUD with a complete project capital needs assessment and reserve for replacement report, and is required to provide HUD with its review of the project capital needs assessment. Critical repairs are any individual or combination of repairs required to correct conditions that (a) endanger the safety or well-being of residents, patients, visitors or passers-by, (b) endanger the physical security of the property, (c) adversely affect project or unit(s) ingress or egress; and (d) prevent the project from reaching sustaining occupancy. MAP Guide, Revised 2002, chapter 11-1.B provides that the lender must provide a narrative analysis describing the mortgage transaction containing a discussion of the characteristics of the proposed loan that make it economically sound or an acceptable risk. The 2009 report used during underwriting listed the general condition of the building as "good," while the 2010 report[1] listed the condition as "fair." The 2009 report listed critical repairs estimated at $99,445, while the 2010 report listed them at $125,295 (a $25,850 increase) (see appendix D). The 2010 report also listed 14 additional noncritical repairs totaling more than $1 million that were not listed in the 2009 report (see appendix E). In response to the 2010 needs assessment, on November 18, 2010, HUD's Detroit field office sent a letter to Prudential and the engineering firm that conducted the needs assessment and noted that the additional repairs could not be explained solely by natural deterioration. HUD requested an alternative explanation for the variance in the two needs assessments. Neither HUD nor Prudential's files contained a reply.

[1] The 2010 project capital needs assessment was ordered by Prudential after it was contacted by the property's management agent, which informed it that tenants had complained about the condition of the property.

In addition, item number 7[2] in the critical repairs for the 2010 needs assessment report was an improper omission from the 2009 report. Specifically, the 2009 report required the same repair for only two units, while the 2010 report required the same repair for 292 units, or 50 percent of the building. It would be reasonable to assume that if the bathroom light fixtures had issues in two units; the inspector would verify whether all bathroom light fixtures required similar repairs or at least inspect them and certify that they were properly working. The improper omission resulted in a health and safety issue. The item involved a non-ground-fault circuit, which was a shocking hazard, considering that it was close to water. Critical repairs are any individual or combination of repairs required to correct conditions that (1) endanger the safety or well-being of residents, patients, visitors, or passers-by; (2) endanger the physical security of the property; (3) adversely affect project or unit(s) ingress or egress; and (4) prevent the project from reaching and sustaining occupancy. In addition, the owner improperly certified that critical repairs were completed before closing.[3] MAP Guide, Revised 2002, chapter 13-17(A)(1), provides that critical repairs must be completed before closing due to safety and security hazards. The needs assessment completed in 2010 showed that 8 of the 10 critical repairs listed in the 2009 needs assessment had not been completed.

A clear understanding of the physical condition of the property was of the utmost importance to HUD's underwriting determination because HUD relies on the third-party report to provide an accurate accounting of the conditions, required repairs, and reserves. As a MAP-approved lender, Prudential was responsible for hiring third-party contractors, such as inspectors and engineers; therefore, it was also responsible for ensuring that the inspector was prudent and the needs assessment report included supported and verifiable information. Prudential signed certifications stating that all in-house, third-party forms, reports, and reviews were reviewed by Prudential in accordance with HUD guidelines. MAP Guide, Revised 2002, chapter 11-1(B), provides that the lender must provide a narrative analysis describing the mortgage transaction, containing a discussion of the characteristics of the proposed loan that make it economically sound or an acceptable risk.

The incomplete critical and noncritical repairs contributed to the property's deteriorating condition (see appendixes D and E), which contributed to the loan's default. Specifically, HUD determined that the property's vacant units were not turned over in a timely manner due to a lack of rental revenue to purchase supplies to complete the units for occupancy. Prudential's files included documentation supporting the same conclusion. Specifically, the default report requested by Prudential showed that the overall condition of the property was unsatisfactory and did not reflect the $1 million investment in noncritical repairs that had been approved for payment by Prudential and HUD between September 2009 and January 2010.

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[2] Item number 7 was to remove or disconnect the receptacle in bathroom lighting fixtures in the dwelling units.
[3] Principal B signed a certification, dated August 6, 2009, which stated that the borrower certified that the critical repairs had been completed. MAP Guide, Revised 2002, chapter 13-17(A)(1)

Prudential Did Not Adequately Assess the Eligibility of the Principals

Prudential did not adequately assess the background and eligibility of the borrower and its principals before approving them for the FHA mortgage.[4] Specifically, one principal's résumé did not adequately outline her multifamily experience. Further, the résumé did not address the type and size of the multifamily developments in which she had experience. It did not specify what her role was in the property developments and the length of time she served in the unstated capacity. MAP Guide, Revised 2002, chapter 8-3(J), provides that the lender's underwriter is to evaluate the résumé of the principal(s). In doing so, the underwriter will look for experience in developing, owning, or building similar multifamily properties. It also explains that the underwriter should pay particular attention to the type and size of previous projects, the geographic area of business involvement, the length of time served in this capacity, and past roles in multifamily business.

Prudential's files also revealed that it did not asses the eligibility of two additional principals that were not listed in the underwriter narrative and the firm commitment loan application. The underwriter narrative listed one sole principal in the borrower's Mortgage Development Team. However, Prudential's files included limited liability company (LLC) formation documents for the borrower, dated February 8, 2008, which included principal A, who was originally listed as the sole principal on the underwriter narrative; principal B; and principal C (see table 1). The document showed that the "authorized principals" were principal B and principal C, and it approved them to conduct business related to Lafayette Towers. Prudential was aware of the additional principals; however, it did not assess their eligibility to participate and did not notify HUD of the additional principals during underwriting. Prudential's files also included an amendment to the February 2008 LLC document, dated August 12, 2009, which excluded principal C and revised principal B's title to authorized signatory. The HUD MAP underwriter who reviewed the firm commitment loan application explained that HUD was unaware that the borrower had additional principals beyond principal A (see table 1).

Table 1: Listing of the borrower's principals

Principals	Position	Did Prudential assess the eligibility of this principal?	Relationship
A	Owner - managing member	Yes (inadequate review of eligibility)	Mother of principal B
B	Managing member - authorized principal	No	Son of principal A
C	Chief financial officer - authorized principal	No	N/A

[4] MAP Guide, Revised 2002, chapter 8-1(B)(1)(a)(1)

Prudential’s failure to assess the additional principals’ eligibility was significant because principal B had significant financial issues. We identified two news articles, which showed that principal A and principal B were principals in another company that owned four additional multifamily highrise properties in Detroit, which had significant financial and creditworthiness issues. The articles explained that the issues ranged from outstanding liens totaling $2.2 million filed by contractors, civil suits, mortgage defaults, and foreclosures. The articles also discussed the background and status of four failed multifamily endeavors. In three of the transactions, principal B purchased the property with cash and then refinanced for a higher amount within a short time, similar to the Lafayette Towers transactions (see table 2).

Table 2: Listing of principal B’s failed multifamily projects

Property	Cash purchase amount	Cash purchase year	Refinance amount	Comments
1	$4,200,000	2005	$15,000,000	The property had been in default since April 2008. Principal B’s company was ordered to pay the refinancing lender $14 million in September 2009.
2	$19,000,000	2005	$25,000,000	No mortgage payments had been made to the lender since April 2009. A new receiver of the building was assigned in October 2009.
3	$15,000,000	2005	$15,000,000	A new receiver was appointed in September 2009.
4	$15,400,000	2003	$17,500,000	The property had been in default since February 2009.

We conducted a lien search for the borrower and the additional principals and found that principal B and the same company mentioned in the articles had 11 liens totaling more than $2.4 million that were filed against him before the loan’s firm commitment in July 2009. MAP Guide, Revised 2002, chapter 8-1(B)(1)(a)(1), provides that one of the major duties and responsibilities is to determine the acceptability of the borrower, if formed, and its key principals through a thorough analysis of their credit, character, financial condition, motivation for ownership, availability of assets for closing, and adequacy of income for total obligations (see appendix C). HUD’s MAP underwriter stated that if Prudential had submitted the loan application with the additional principals and it discovered that principal B had more than $2 million in liens during processing, she would have been identified as a credit or financial risk. HUD’s MAP underwriter added that HUD would have considered ways to mitigate the risk, which could have included removing that principal from participation in the transaction.

Prudential essentially allowed the borrower to circumvent HUD MAP requirements. It should have practiced due diligence and conducted a complete review of the borrower’s financial capacity and eligibility. MAP Guide, Revised 2002, chapter 11-1(B), also provides that the narrative analysis submitted by the lender must describe the mortgage transaction and evaluate the financial capacity of the principals of the borrower and its ability to repay the loan. In addition, Prudential’s failure to properly assess the background and eligibility of each principal resulted in the approval of a borrower that contributed to the project’s default. Specifically,

Improper Property Management

The borrower improperly took over the property's management function without prior HUD knowledge. HUD's records showed that the approved management agent notified it that it had chosen to resign as agent due to the borrower's continued interference with the management of the property.[5] HUD determined that the borrower's interference jeopardized the performance of the FHA-insured mortgage. Prudential also identified the inappropriate management interference and recommended that HUD exercise its right to require the borrower to immediately stop self-managing the property.[6] HUD further determined that when the borrower inappropriately took over the management function, it admitted several residents who were credit risks. HUD determined that the property's tenants' accounts receivable[7] total had accumulated to an excessive amount of $314,319 because rents were not collected in a timely manner

We reviewed HUD's correspondence, which identified many examples of the improper and inadequate management of project funds, including but not limited to a misappropriation of $15,275 in unauthorized distributions to an affiliated company for asset management fees, unsupported costs totaling $13,240, unnecessary costs totaling $1,189,[8] a failure to document or obtain required bids, improperly encumbered property with liabilities totaling more than $600,000, and more than $39,000 in accounts payable for inappropriate management fees to be paid to an affiliated company with a name similar that of the borrower.[9]

Prudential Did Not Adequtely Assess the Property's Financial History

Prudential did not adequately assess the property's financial history. Specifically, it did not obtain all of the required financial statements on the property for the previous 3 years. Prudential explained that during underwriting, the borrower stated that it could not obtain the required financial statements because the previous management agent no longer managed the property. Prudential also explained that the property's last 3 years' financial statements were not required because the property was recently purchased; however, the MAP Guide does not exclude recently purchased properties from the requirement. MAP Guide, Revised 2002, chapter 11-1(B), provides that a narrative analysis must be submitted by the lender to describe the mortgage transaction and contain a discussion of the property's financial analysis. MAP Guide, Revised 2002, chapter 8-4(B) (3), provides that the borrower must submit the last 3 fiscal years' financial statements on the facility. It also provides that there may be circumstances beyond the borrower's control under which the financial statements cannot be obtained. In these instances, the borrower must submit evidence satisfactory to the lender that the financial statements were

[5] HUD Handbook 4381.5, section 2.12

[6] On May 12, 2010, HUD conducted a management occupancy review of the property and allowed Prudential to accompany it during the review. Prudential's recommendation to HUD was based on the results of the review.

[7] HUD Handbook 4370.1, exhibit 2.14.G

[8] HUD determined that these expenses were inappropriately disbursed from the operating account for the borrower's travel expenses. HUD Handbook 4381.5, section 3.1

[9] Paragraph 6 of the regulatory agreement, page 4

not obtainable. The MAP Guide provides that the lender's case file must contain (1) a written statement by the borrower explaining why the records were not obtainable and (2) a memorandum from the lender stating that it evaluated the borrower's statement and agreed that the information was unattainable. Prudential's and HUD's files should have included the required documentation. The intent of the financial statement requirements in the MAP Guide is for the lender to document and analyze the property's financial capacity to enable the lender and HUD to make a sound economic decision regarding risk associated with approving a refinance mortgage. Prudential's failure to obtain the required financial statements resulted in HUD's inability to completely assess the property's financial position and potentially unreliable income and expense data used during the appraisal. HUD's records included notes from the reviewing MAP underwriter, which stated that the financial information provided in the application was limited and not thorough.

The Appraisal Report Was Unsupported

Prudential did not ensure that the appraisal report was supported and allowed the value to be overstated by more than $11 million. As a MAP-approved lender, Prudential was responsible for hiring third-party contractors, such as an appraiser; therefore, it was also responsible for ensuring that the appraiser was prudent and the appraisal included supported and verifiable information. Prudential signed certifications stating that all in-house, third-party forms, reports, and reviews were reviewed by Prudential in accordance with HUD guidelines. Prudential's appraiser determined that the value was $28.6 million. Based on information also available at the time of Prudential's appraiser review, we recalculated the value to be $17.5 million, more than $11 million less than Prudential's appraised value (see table 3). MAP Guide, Revised 2002, chapter 11-1(B), provides that the lender must review in-house and third-party reports and determine that the processing of the loan is in accordance with the requirements of the Guide and that the proposed loan represents an acceptable risk or is economically sound.

We reviewed the MAP loan default review conducted by a third party, which included a desk review of the appraisal. The reviewer's methodology relied on the appraiser's conclusions, and it did not verify the data used in the appraisal. We also identified discrepancies in the review, including a failure to identify that the subject property had sold within the past 3 years.

Table 3: Valuation approach

Valuation approach	Land value		Difference
	Prudential	Office of Inspector General (OIG)	
Market approach[10]	$28,600,000	$17,520,000	11,080,000
Income capitalization approach[11]	$28,600,000	$18,000,000	10,600,000
Cost approach[12]	$28,600,000	$15,900,000	12,700,000
Value conclusion	$28,600,000	$17,520,000	$11,080,000

We reviewed the appraisal and identified several deficiencies that contributed to the overstatement of the value. The deficiencies included inappropriate comparable sales, inappropriate market data adjustments, unreasonable operating expenses, and unsupported capitalization rates[13].

Inappropriate Comparable Sales

Improved sale[14] 4 was not comparable due to the property style. Specifically, improved sale 4 consisted of townhomes and duplexes, while the subject property was a 22-story highrise (see table 4). Prudential's appraisal also showed that improved sale 5 had 184 apartments; however, the building consisted of only 65 apartments at the time it was sold. Therefore, the price per unit calculation and any analysis related to sale 5 would not be reliable. In addition, the appraiser failed to use the previous April 22, 2008 (less than 1 year from the effective date of the appraisal), sale of the subject property as a comparable sale, although it was most representative of the subject. The subject property previously sold for $16 million, and the appraiser valued the property at $28.6 million less than 1 year later with only $1.4 million in repairs. Prudential's appraiser documented the sale in the appraisal but did not document an analysis to determine whether the sale was an arms-length transaction or below market. MAP Guide 7-11(A), requires that the firm commitment application includes evidence of the last arm's length transaction and price. The previous April 2008 sale was considered a market value sale and would have been one of the best indicators of the subject property's value. The appraisal did not document why the previous sale was not included as a comparable. MAP Guide, Revised 2002, chapter 7-1(A),

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[10] A method of determining the value based on the selling price of similar items. A property's value can be estimated by reviewing comparables that are similar in size and features that are located near the subject property.
[11] A method that considers the income-generating potential of a property based on projections of income and expenses that could be realized if the property were used to generate income into a value conclusion
[12] A method that assumes that the price someone should pay for a property should not exceed what someone would pay to build an equivalent building. In this approach, the market price of the property is equivalent to the cost of land plus cost of construction less depreciation. It is often most accurate for market value when the property is new.
[13] A rate of return on a real estate investment property based on the expected income that the property will generate. Capitalization rate is used to estimate the investor's potential return on his or her investment.
[14] Improved property is land that has some improvements or land that has been partially or fully developed for use. An improved sale is a comparable used to support the highest and best value of a particular property.

provides that the valuation analysis is made to evaluate the existing or proposed property as security for a long-term HUD-insured mortgage. Section 7-4 states that an appraisal must adequately describe the geographic area, neighborhood, rental competition, sales comparable, site, and improvements. Uniform Standards of Professional Appraisal Practice (USPAP) Standard Rule 1-5 and Standard Rule 2-2(viii) require that appraisers analyze and report all sales of the subject property that occurred within the 3 years before the effective date of the appraisal.

Table 4: Land sales used by Prudential's appraiser and OIG's determination

Improved sales	Price per unit	Distance (miles)	Style	OIG determined appropriate comparable (yes-no)
Subject property*	$27,397	0	Highrise	Yes*
1	$29,788	2.3	Midrise	Yes
2	$24,809	1.7	Highrise	Yes (inappropriate adjustments)
3	$26,150	10.9	Highrise	Yes (inappropriate adjustments)
4	$45,662	16.2	Townhome	No – property style incomparable (inappropriate adjustments)
5	$17,120	1.5	Highrise	Yes (inappropriate adjustments, unverified sale, overstated unit amounts, inaccurate price per unit, superior location)

* The subject property previously sold in April 2008 and should have been used as a comparable sale.

Inappropriate Market Data Adjustments

Prudential's appraiser made two sets of adjustments to the comparable sales. The first set of adjustments was made in the original report, and it showed that a positive net operating income adjustment was made to each of the comparable sales, indicating that each sale was inferior to the subject based on its income-producing capabilities. HUD reviewed the appraisal and required the appraiser to amend the market value conclusion because it was unsupported. The appraiser revised the analysis; however, it yielded a similar value conclusion, with positive overall adjustments ranging from 10 to 65 percent with inadequate support to justify why the adjustments were made. The 10 percent adjustment to improved sale 4, which was previously discussed, consisted of townhomes and duplexes and was not comparable to the subject property. The other improved sales had positive overall adjustments ranging from 45 to 65 percent (see table 5). The adjustments were excessive and indicated that the improved sales were not comparable to the subject property or the adjustments were made to support an unsupported value conclusion. The USPAP Standard Rule 1-4 requires the appraiser to collect, verify, and analyze all information necessary for creditable assignment results. Standard Rule 2-2(viii) requires the appraiser to describe the information analyzed; the appraisal methods and techniques employed; and the reasoning that supports the analysis, opinions, and conclusions.

Table 5: Unsupported market data adjustments

Improved sale	Price per unit	Adjustment percentage	Adjusted price per unit	Price per unit increase after adjustment
1	$29,788	65 percent	49,150	19,362
2	$24,809	55 percent	$38,454	13,645
3	$26,150	55 percent	$40,533	14,383
4	$45,662	10 percent	$50,605	4,943
5	$17,120	45 percent	$25,010	7,890

Unsupported Operating Expense

Prudential's appraiser understated the property's operating expenses. We reviewed form HUD-92264, HUD Multifamily Appraisal Report, and the property budget comparison report and determined that the property's operating expenses from 2005 through 2007 were within a stable range with an average of $5,860 per unit. The budget comparison report showed that expenses were only $4,326 per unit in 2008. Prudential's appraiser determined that expenses before reserves and management fees were $5,122 per unit. The expense per unit before reserves and management fees should have been $5,604 per unit based on historical levels. The appraiser's estimate considered activity from 2005 through 2008; however, the lower expenditures in 2008 skewed the estimate. The reduced expenses were not consistent with the appraiser market conclusion. Specifically, the modest expense estimate was not commensurate with the appraiser's conclusion of a stressed financial time and high unemployment period in the area. It would have been reasonable to estimate that the expenses would remain at or above the historical levels in 2005 through 2007. The understated expenses placed the property at a disadvantage in its ability to pay the mortgage and increased the risk of default. MAP Guide, Revised 2002, chapter 7-7, provides that a determination is made of the portion of gross income, which must be used to maintain, operate, and repair the property and to defray the costs of ownership arising from it.

Unsupported Capitalization Rates

Prudential's appraiser failed to properly analyze improved sales to arrive at the capitalization rate and failed to evaluate the risk associated with properties in the Detroit market in 2008 and early 2009. The appraiser calculated a capitalization rate of 8.5 percent by applying four different capitalization methods used to capitalize the subject property's net operating income for the income approach.[15] The appraiser's review of the market painted a negative picture of the market, which indicated that investors would be more reluctant to invest in real estate in the Detroit area and would want a greater return on capital when they did. This review indicated that a higher capitalization rate would be

[15] A method that considers the income-generating potential of a property based on projections of income and expenses that could be realized if the property were used to generate income into a value conclusion

more representative of the subject property. However, the lender's appraiser determined that the capitalization rate was only 8.5 percent, which yielded a value of $28.6 million. We determined that the capitalization rate for the property should have been 9.9 percent, which yielded a value of only $18 million under the income approach.[16] We made our determination using data that were available to the appraiser at the time of his review. MAP Guide, Revised 2002, chapter 7-7, provides that a determination is made of the portion of gross income, which must be used to maintain, operate, and repair the property and defray the costs of ownership arising from it. USPAP Standard Rule 1-4(c)(iii) requires appraisers to analyze comparable data as is available to estimate rates of capitalization and rates of discount. We determined that each of the following methods was flawed and unsupported (see table 6).

Table 6: Prudential's appraiser capitalization rate method conclusions

Capitalization rate method	Rate	Cause of unsupported capitalization rate
Market extraction	8.50	Incomparable sale and failure to apply subject property's previous sale
Korpacz survey	8.00	Rate not supported by data included in the report
Debt coverage ratio	8.98	Inaccurate mortgage constant
Band of investment	8.71	Inaccurate mortgage constant and no support for equity dividend rate
Rate conclusion	**8.50**	

Conclusion

Prudential certified that the MAP application for the FHA-insured multifamily loan for Lafayette Towers was prepared and reviewed in accordance with HUD requirements. However, it did not properly analyze (1) the project capital needs assessment appraisal, (2) the experience and financial capacity of the borrower, (3) the financial history of the property, and (4) the appraisal. In addition, Prudential did not conduct due diligence, practice prudent underwriting, and conduct a sufficient review of related documents and third-party reports, which HUD relied on for insuring Lafayette Towers.

HUD placed confidence in Prudential's integrity and competence to properly implement the MAP Guide and other relevant guidance during the underwriting process; however, Prudential did not comply with HUD requirements, which resulted in HUD's approval of a loan with significant financial risk. The owner defaulted on the mortgage loan in less than 10 months, resulting in a loss to HUD of more than $15 million.

[16] Our capitalization rate determination included the previous 2008 sale of the property, which contributed to our higher 9.9 percent rate. Prudential's appraiser did not include the sale in his analysis.

Recommendations

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs

1A. Refer Prudential to the Mortgagee Review Board to take appropriate action for violations that caused $15,727,529 in unnecessary or unreasonable cost to HUD's FHA insurance fund or other administrative action as appropriate.

We also recommend that HUD's Associate General Counsel for Program Enforcement

1B. Determine legal sufficiency and if legally sufficient, pursue remedies under the Program Fraud Civil Remedies Act against the borrower, its principals, or both for incorrectly certifying that the property's critical repairs were completed before loan closing.

We further recommend that the Director of HUD's Departmental Enforcement Center

1C. Pursue administrative actions, as appropriate, against the responsible party for the material underwriting deficiencies cited in this report.

Scope and Methodology

We conducted the audit from October 2014 to June 2015 at the HUD Office of Multifamily Development in Detroit, MI, and the Atlanta, GA, HUD OIG regional office. The audit covered the period April 2008 through March 2012 and was adjusted as necessary.

The review was conducted based on information contained in Prudential's project files with no reliance on systems used and maintained by Prudential. The records obtained from Prudential and reviewed for audit evidence are not computer generated or based; therefore, we did not conduct an assessment of data reliability.

To accomplish our objective, we reviewed

- Organizational charts effective from August 1, 2008, to December 31, 2012;
- Applicable laws, regulations, and relevant HUD program requirements and HUD's MAP Guide;
- Prudential's policies and procedures that govern the MAP program related to preparing, processing, and submitting the subject application;
- A list of current and past employees, including job function, date of hire, and date of termination, if applicable, who were directly or indirectly involved with the processing or approval of the loan;
- The appraisal conducted during loan origination;
- The capital needs assessments conducted during loan origination and after loan default; and
- Prudential's and HUD's project files related to Lafayette Towers, including but not limited to correspondence files, emails, processing and underwriting files, firm applications, repairs, and default activity.

We conducted interviews with management agents, Prudential's employees, and HUD employees. We also conducted a site visit of Lafayette Towers in March of 2015. We determined the loss to the FHA fund to be more than $15 million (the amount of the claim paid, $21,576,859, minus the amount of the sale for $5,849,330 equals $15,727,529).

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

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

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Policies, procedures, and other management controls implemented to ensure that Prudential underwrote and processed the mortgage for Lafayette Towers in accordance with HUD's MAP requirements.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

We evaluated internal controls related to the audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as whole. Accordingly, we do not express an opinion on the effectiveness of Prudential's internal control.

Appendixes

Appendix A

Schedule of Questioned Costs

Recommendation number	Unreasonable or unnecessary 1/
1A	$15,727,529
Totals	

1/ Unreasonable or unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business. We determined the unreasonable cost to be the loss to the FHA fund. We determined the loss to the FHA fund to be more than $15 million (the amount of the claim paid, $21,576,859, minus the amount of the sale for $5,849,330 equals $15,727,529).

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation | **Auditee Comments**

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July 14, 2015

Nikita N. Irons
Regional Inspector General for Audit
Office of Audit (Region IV)
75 Spring Street, SW, Room 330
Atlanta, GA 30303

Re: Response to HUD Office of Inspector General Draft Audit of Lafayette Towers

Dear Ms. Irons:

This letter is in response to the HUD Office of Inspector General's ("OIG") request that Prudential Huntoon Paige Associates, LLC ("PHP") comment on its June 30, 2015 draft audit report ("Draft Report"). The Draft Report relates to PHP's underwriting of the refinancing of a multifamily housing project known as Lafayette Towers (the "Project" or "Lafayette") that was refinanced by a mortgage loan (the "Loan") insured by HUD under Section 223(f) of the National Housing Act. PHP made the Loan under the Multifamily Accelerated Processing ("MAP") Program.

I. INTRODUCTION

The conclusions and recommendations in the Draft Report are deeply flawed in several respects. First, OIG auditors with no experience underwriting loans utilizing the Multi-Family Accelerated Processing Guide ("MAP Guide") have misconstrued or failed to consider the appropriate sections of the MAP Guide and instead, improperly substituted their own post hoc judgments as to how a loan should be underwritten.

Second, the Draft Report fails to acknowledge HUD's significant role in underwriting and approving the Loan. For example, HUD reviewed and approved underwriting-related documentation and certified that the third-party reports (that the OIG now criticizes) complied with HUD requirements. Specifically, HUD reviewed and approved both the appraisal and the PCNA.

Third, the Draft Report ignores the conclusions of a loan default review ("LQMD Review") conducted by an independent third party, CohnReznick, which concluded that the loan was underwritten to MAP Guide standards, that the appraisal complied with the requirements of the Map Guide and that the default was largely the result of borrower fraud and mismanagement.

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For these reasons, PHP requests that the OIG revise its report to correct these significant flaws or that it withdraw the Draft Report and close the audit altogether.

Comment 1

A. The OIG has ignored the requirements of the MAP Guide and is improperly substituting its own judgment as to how the Lafayatte loan should have been underwritten

The principal flaw in the Draft Report is that the OIG improperly substitutes its judgment in place of the specific requirements of the MAP Guide. The OIG initially acknowledges HUD's significant role in underwriting a loan under the MAP guide:

> Under HUD's Map Program, approved lenders prepare, process, review, and submit loan applications for multifamily mortgage insurance....[T]he lender submits the firm commitment application, including a full underwriting package, to HUD to determine whether the loan is an acceptable risk. Considerations include market need, zoning, architectural merits, capabilities of the borrowers, and so forth. **If HUD determines that the project meets program requirements, it issues a firm commitment to the lender for mortgage insurance.** (Emphasis added).

The stated objective of the Draft Report is to determine whether the Loan was underwritten and processed in accordance with the Map Guide. Unfortunately, the OIG fails to consider the appropriate provisions of the MAP Guide in its review. For example, the OIG alleges that PHP "did not ensure that the capital needs assessment used during underwriting was complete and accurate." The OIG cites to MAP Guide Revised 2002, chapter 11-1(B) to contend that PHP was responsible for "ensuring that the inspector was prudent and that the needs assessment report included supported and verifiable information." The OIG's statement completely ignores the sections of the MAP Guide that actually relate to the project capital needs assessment, chapter 5.25 and appendix 5M. Those sections are contrary to the OIG's position and set forth PHP's actual obligations. Citing those sections of the MAP Guide, the OIG incorrectly contends that PHP "did not ensure that the appraisal report was supported and adequate." The OIG contends, among other things, that PHP should have second-guessed land values and comparables used by the professional appraiser retained by PHP. The OIG is wrong. The MAP Guide does not require PHP to substitute its own judgment for that of the retained third-party experts.[1]

[1] In fact, an appraiser permitting a client to interfere, second-guess, and edit an appraisal in the manner suggested by the OIG in the Draft Report would most likely violate the USPAP Ethics Rule, which requires an appraiser "to perform assignments with impartiality, objectivity, and **independence**."

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The MAP Guide outlines both the qualifications and responsibilities of the Lender and the responsibilities of HUD as it relates to underwriting, third party report review and the PCNA review. Those obligations are found in chapters 5.25, 8.1, 11.1, and 11.2 of the MAP Guide. Those individual requirements are discussed below.

1. Lender Underwriting Qualifications and Responsibilities

Comment 1

The MAP Guide identifies the lender's qualifications as follows:

A. Lender Qualifications

1. The Lender's underwriter must have basic knowledge and skills in a variety of financial areas, including:

   a. General experience in banking, accounting, finance, or commercial lending, and in multifamily mortgage financing.

   b. The ability to analyze corporate financial statements, including, but not limited to, balance sheets, income statements, and statements of changes in financial position, and to evaluate the credit acceptability of individuals, partnerships, corporations and other entities.

   c. A broad knowledge of lending practices for mortgages and construction loans and the financial structures of individuals, partnerships and other entities.

As detailed above, the Map Guide does not require that lender's underwriter be a certified appraiser who is qualified to conduct a technical review of the third-party appraisal. The MAP Guide also does not require the underwriter to be a contractor or building inspector. Instead, the MAP Guide requires the lender's underwriter to be a generalist who understands lending practices. A review of the lender's duties during underwriting confirms that conclusion:

a. Duties and responsibilities associated with the application underwriting are as follows:

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Comment 1

(1) Makes a determination of the acceptability of the general contractor, the sponsor, the mortgagor, if formed, and its key principals through a thorough analysis of their credit, character, financial condition, motivation for ownership, availability of assets for closing and adequacy of income for total obligations.

(2) Uses trade references, bank references, credit data and construction experience resumes in analyzing the construction capability of the general contractor including financial stability, and ability to complete the project.

(3) Determines the recommended maximum mortgage amount and other key terms of the loan.

With respect to an appraisal, as detailed below, the Map Guide requires that lenders hire a qualified appraiser to appraise the property. The lender then reviews the report to ensure that it contains the information required by Chapter 7.4 of the Map Guide.

Specifically, section 11.1C of the MAP Guide, requires PHP to (i) review[2] the appraisal report, (ii) hire a well-qualified appraiser, (iii) confirm that the forms were prepared as required by the MAP Guide, and (iv) conclude, based on the information provided, that the loan presents an acceptable risk to HUD.[3]

[2] The review in question is a general review of the appraisal to confirm it contains the information necessary for the underwriting analysis and not a detailed technical review. No other conclusion is possible for two reasons. First, as discussed above, the lender is not required to be a qualified appraiser. Second, as discussed below, the MAP Guide requires HUD to perform a technical review of the third-party reports.

[3] Section 11.1C provides:

Due diligence. With the Firm Commitment package the MAP Lender certifies that:

1. The Lender has reviewed all in-house and third party forms/reports/reviews.

2. The preparer of the forms/reports/reviews is qualified as required by the guide, and has the insurance, if any required by this guide.

3. The forms/reports/reviews were prepared in the manner required by the guide and the forms/reports reviews are complete and accurate.

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2. HUD's Underwriting Responsibilities

By contrast, HUD has more significant responsibilities relating to the third-party reports. Chapter 8.1 outlines HUD's underwriting responsibilities as follows:

C. Major Duties and Responsibilities of HUD

Comment 1

1. HUD is to perform the following major mortgage credit functions during the application underwriting and construction periods:

a. During application underwriting:

(1) Reviews the Lender's mortgage credit report(s) regarding the acceptability of the sponsor, mortgagor, and its key principals, and the contractor.

(2) Performs HUD 2530 Clearance Process.

(3) Determines the maximum mortgage amount and other key terms of the loan.

(4) Determines actual financial settlement requirements.

(5) Reviews initial and final closing documents for compliance and acceptability.

Chapter 11.2B of the MAP Guide, entitled "HUD Field Office Underwriting Review" sheds additional light on HUD's role in the process by outlining the significant technical review of the third-party reports required by HUD:

---

4. The proposed loan represents an acceptable risk to the Department (replacement cost programs) or is economically sound (value programs), based upon the Lender's review and analysis and the proposed loan and processing complies with all FHA statutory regulatory and administrative requirements.

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Comment 1

> **HUD Reviewers Signature and Certifications:** Upon determination of acceptability for processing, the HUD reviewers should sign their individual Technical Reviews and when determined acceptable for processing, the Master HUD 92264 prepared by the lender. The Master HUD 92264 is the most critical underwriting document because it is a summarization of key technical processing conclusions which, along with the HUD Form 92264A, are the basis for the FHA Firm Commitment. Since MAP requires a technical review of the lender's underwriting conclusions, the Master HUD Form 92264 is the logical and appropriate form that HUD reviewers should sign or co-sign to authenticate their review as opposed to individual 92264s prepared by third party contractors.... Long before the implementation of MAP, it has been an FHA basic procedure to require the HUD review appraiser's signature on the aforementioned forms. The Department believes that the continuation of this long standing policy clearly documents the underwriting conclusions and decisions made by HUD staff.... HUD review appraiser signatures, on such Forms as the 92264, attest to the quality of the review, that the processing is in compliance with MAP technical instructions, that it is free of errors and has no omissions, and that the appropriate appraisal procedures and analysis have been completed. Additionally, as the MAP Guide currently states, MAP requires a Technical Review of appraisals.
>
> * * *
>
> The HUD's review appraisers' technical review should comply with USPAP Standard 3. To document his review, the review appraiser should complete Appendix 7C.1 and the review report must include a signed certification as prescribed by USPAP Standard 3.

The review standards set forth in USPAP Standard 3 are rigorous. For example, USPAP Standards Rule 3-3(a) requires a review appraiser to "develop an opinion as to whether [the appraiser's] analyses are appropriate … [and the appraiser's] opinions and conclusions are credible. The review appraiser must also develop the reasons for any disagreement. USPAP Standards Rule 3-3(b) requires a review appraiser to "develop an opinion as to whether the report is appropriate and not misleading … [and to] develop the reasons for any disagreement."

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MAP Guide Chapter 11.2F further requires HUD to review the transaction itself to confirm that the lender's underwriting was supportable and that the transaction represents an acceptable risk to HUD:

Comment 1

> **Underwriting recommendation.** Each HUD technical specialist by discipline would review the respective Lenders' reviewers' reports, the underwriting summary and certain key elements of the application specified in the Guide. The HUD technical specialist would review the quality of the Lender's review and the transaction itself. The HUD technical specialists would not reprocess the case. However, if the technical specialist determines that certain underwriting conclusions are not supportable and affect HUD's risk, the specialist would recommend modification of the Firm Commitment application, recommend that the Lender modify the application or recommend a rejection.

Once HUD completes its technical review, Chapter 11.2F obligates HUD to draft a memorandum summarizing the multiple technical reviews of the underwriting package (including, among other things, the adequacy of the initial operating deficit) and to determine whether to recommend the loan for approval:

> Upon completion of the technical reviews and the environmental assessment, the Team Leader will prepare a memorandum to the director summarizing the individual reviews of the specialists, any proposed waivers of FHA underwriting requirements and the Team Leader's overall recommendation.
>
> * * *
>
> Attached to the memorandum will be . . . . specific HUD staff reviews, the Lender narrative summary, the Lender's technical reviews and, if recommended for approval, a proposed FHA Firm Commitment with Forms 92264 and 92264a signed by the HUD reviewers and Team Leader.

Comment 1

PHP and HUD both fulfilled their respective obligations under the MAP Guide in underwriting the Loan. PHP provided the required documentation to HUD, including the third-party reports as outlined above.

HUD analyzed the information provided by PHP and determined that it complied with HUD requirements and supported the proposed Loan. HUD reviewed all the information and

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ultimately decided that the underwriting complied with the MAP Guide and supported the proposed Loan. HUD then concluded that the proposed loan was an acceptable risk to HUD and issued a firm commitment.

Comment 1

Despite both PHP's and HUD's satisfaction of their respective requirements under the MAP Guide, the OIG has in 2015 chosen to second-guess the judgments that PHP and HUD professionals made in 2009 during the underwriting process, which judgments that were based on reports of independent, HUD-approved appraisers and analysts.[4]

3. Lender Project Capital Needs Assessment Responsibilities

Chapter 5.25 of the MAP Guide requires the lender to present to HUD a complete project capital needs assessment and replacement reserve escrow ("PCNA") report prepared in accordance with appendix 5M of the MAP Guide. The lender is also to provide its review of the PCNA report and a completed A/E portion of form HUD 92264. Appendix 5M more clearly details the lenders responsibilities with respect to the PCNA report. The components of the PCNA report include a physical inspection report ("PIR"), a lender review of the PIR, the lender computation of replacement reserve account, and the lender statement of needs and resources. Section II of Appendix 5M details the lenders responsibilities with respect to the PIR as follows:

> II. The Physical Inspection Report (PIR)
>
> A. The Lender hires a "Needs Assessor" to prepare a PIR on the Project.
>
> 1. A Needs Assessor is any firm or individual, including the Lender's architectural and cost analysts, qualified by training and experience to evaluate building systems and site conditions and to provide cost estimates.
>
> 2. The Needs Assessor and its Subcontractors participating in the preparation of the PIR may not have an Identity of Interest with the Mortgagor, sponsor, and managing agent (if any) of the proposed Project. An arms-length relationship is essential.

[4] The appraisers and analysts were approved by HUD at the commencement of underwriting. As set forth in more detail below, each third-party appraiser identified in this report has significant multi-family experience.

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Appendix 5M them goes on to identify the specific sections and requirements of the PIR. The Appendix then makes clear that it is the hired "Needs Assessor" that conducts property inspections:

D. Conducting the Inspections.

1. The Needs Assessor may find it desirable to subcontract with other entities or persons for portions of the Project's physical inspection. For example, the Needs Assessor may wish to engage the services of a roofing subcontractor to furnish a roof inspection, a paving subcontractor to inspect the parking lots and sidewalks, a plumbing subcontractor to inspect the plumbing system, etc.

2. The Department is leaving the working details of these arrangements to the Lender and the Needs Assessor hired by the Lender.

3. The Needs Advisor must inspect enough dwelling units to be able to formulate an accurate estimate of repair, replacement and major maintenance needs.

   a. In some cases, depending on the size and condition of the Project, all or nearly all unites will need to be inspected by the Needs Assessor.

   b. In other cases, a lesser number of units may need to be inspected by the Needs Assessor.

   c. The Department expects that appropriate statistical sampling methods and techniques will be used by the Needs Assessor to reach their conclusions about repair needs.

The appendix goes on to describe the Needs Assessor's responsibilities in estimating replacement and major maintenance needs costs and projecting repairs, replacements and major maintenance costs. *See* Appendix 5M II, E. and F. After outlining the Needs Assessor's

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responsibilities, Appendix 5M describes in specific detail the Lender's responsibilities for reviewing the PIR.

III. Lender Review of the Physical Inspection Report

The Lender reviews the PIR and makes any appropriate adjustments as indicated below.

A. The Lender's review is to determine whether:

1. The PIR covers the appropriate mortgage term;

2. All items requiring action during the mortgage term are included in the PIR;

3. An adequate sampling of units was made, and management reported replacements have been verified and considered;

4. Appropriate ages are given for individual elements and whether any deviations from the expected useful lives are adequately justified; and

5. The PIR contains any material mathematical errors.

Nowhere in the list of Lender's responsibility is there an obligation for the Lender to ensure that the inspector was prudent and that the needs assessment report included supported and verifiable information.

Comment 1

4. HUD's PCNA Review Responsibilities

By contrast, HUD does have the responsibilities to review the PCNA report that the OIG claims belong to the Lender. As noted in Section VI:

VI. HUD Review.

A. The HUD Office should:

1. Review the PCNA for completeness and adequacy. The review should include a careful examination of the Department's long-term risk associated with

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non-traditional calculation of annual deposits to the replacement reserve.

2. Discuss all weaknesses or inadequacies of the PCNA with the Lender in an effort to reach consensus about the needs and resources of the project. The results of these discussions and agreements reached must be incorporated into the firm commitment and loan closing documents.

The MAP Guide further provides that HUD is responsible for imposing its own methodology for computing the annual deposit to the replacement reserve if it disagrees with the PCNA and that HUD will reevaluate and adjust the replacement reserve as necessary.

As set forth above, the MAP Guide details the obligations of the Lender, HUD, the appraiser and the Needs Assessor in underwriting a Section 223(f). The identified responsibilities clearly demonstrate that the OIG draft report did not properly consider the appropriate sections of the MAP Guide in issuing its draft report.

Comment 2

B. HUD certified the accuracy and appropriateness of the judgments that the OIG now cites as evidence that PHP did not properly underwrite the Loan. HUD reviewed the PCNA report for completeness and accuracy

As set forth above, HUD fulfilled its responsibilities for the Loan by reviewing the underwriting and third-party reports and concluded that the underwriting and the third-party reports that the OIG now criticizes complied with both the Uniform Standards of Professional Appraisal Practice ("USPAP") and with applicable MAP Guide requirements. HUD certified compliance utilizing MAP Guide Appendix forms 7.C.1 and 7.C.2.

In addition, PHP hired a Needs Assessor to conduct a PIR requirement as required by the MAP Guide. PHP conducted the specific review of the specific items required by the MAP Guide. HUD then reviewed the PCNA report for completeness and accuracy. HUD did not disagree with the findings of the PIR as it did not impose its own requirements with respect to a replacement reserve. Accordingly, PHP fulfilled its obligations under the MAP Guide with respect to underwriting the loan.

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Comment 3

C. **An independent reviewer concluded that PHP complied with MAP Guide requirements in underwriting the loan**

CohnReznick, a consulting firm that, among other things, reviews loans that go into early default was retained to review the Loan as required by the MAP Guide.[5] The purpose of the LQMD Review was to:

- Analyze valuation and underwriting assumptions and comparison to actual activity;
- Identify issues with potential to impact the performance of the loan;
- Identify deviations from the Lender's then-applicable defined loan origination procedures and the current quality control process;
- Review controls deficiencies and recommend corrective action; and
- Compare processes used at the time the Loan was originated to best practices.

CohnReznick engaged John Doyle, MAI, to conduct a review of the appraisal. Mr. Doyle concluded that "the appraisal report generally satisfied the reporting requirements of the MAP Guide and the USPAP standards."

With respect to PHP's underwriting, CohnReznick engaged "Mary Gump, a former FHA/Fannie Mae/Freddie Mac Underwriter and current MAP annual quality control reviewer, to conduct a review of the Lender's underwriting documents against HUD's MAP Guidelines.... The Review found that the Lender's underwriting documentation generally satisfied the reporting requirements of the MAP Guide."

Comment4

D. **The OIG failed to consider numerous factors that led to the Lafayette default.**

The LQMD report contained a section entitled "Summary of the Primary Factors Contributing to the Loan Default." Significantly, the CohnReznick report does not identify any problems with underwriting, the appraisal, or the PCNA report as contributing in any way shape or form to the loan default. Indeed, the LQMD report concludes that underwriting was appropriate and the default was caused by misappropriation of funds, deteriorating property conditions and inadequate property management:

[5] The OIG was aware of and had a copy of the LQMD Review.

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> Between 2009 and 2011, the Detroit multi-family rental market was undergoing an extraordinary state of upheaval. The rapid and unprecedented downturn in the national economy disproportionately affected the greater Detroit real estate market because of its reliance on the automotive industry. Both the Lender and the third-party appraiser were aware that the Property was located in a declining real estate market as evidenced by the market risks identified in the Lender's underwriting narrative as well as description of the market characteristics contained within the appraisal. The underwritten 10% vacancy rate assumption, which was supported by the third-party appraiser, appeared to be appropriate given the market condition at the time of underwriting.
>
> The Lender's underwriting assumptions were generally consistent with the conclusions found in the appraisal. While the local economy was weakening as a result of the national economy, it does not appear that it was the primary factor driving the high vacancies at the Property. Based on the market study update provided by Novogradac & Company in January 2011, market comparables were experiencing vacancy rates averaging 10.7% which was less than the 13.2% overall vacancy rate contained in the original 2009 appraisal.
>
> Overall, it appears that the unexpectedly high vacancy rate at the Property was cause my multiple factors including the misappropriation of funds, deteriorating property conditions as a result of incomplete construction and deferred maintenance, and inadequate property management.

The LQMD report notes that in October of 2009, four months after closing on the loan, the Lender learned from multiple publications that the four properties owned by the principal's family business were facing foreclosure as a result of lawsuits filed by residential and commercial tenants, mechanics liens, and overdue mortgage payments. The Lender immediately notified HUD of the same. HUD then became aware, possibly as early as the fall of 2009, that the mortgagor may have been misappropriating funds set aside for non-critical repairs and may have been interfering in operations of the Property. PHP was not informed of those issues until May 2010 when it immediately notified HUD. By June 2010, HUD had sent a cease and desist letter to the mortgagor and approved a request from PHP to use remaining funds in the non-critical repair escrow and the replacement for reserve fund to complete necessary repairs to the Project, satisfy outstanding liens, and have a new PCNA performed on the Property.

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Accordingly, the new PCNA was performed due to the suspected Borrower fraud, mismanagement, and failure to perform required repairs.

The LQMD report concludes:

> From the documentation provided, it appears the Lender was diligent in their efforts to prevent the Loan default and to fully cooperate with DEC. We reviewed documentation of these efforts that included internal and external correspondence on a weekly basis between May 2010 and April 2011. The effort appears to have been well resourced. We note that in addition to the asset management staff performing multiple site visits and fully communicating their efforts to the Detroit Multifamily office and DEC, senior staff members including the Chief FHA Underwriter, the Director of FHA Asset Management and the President/CEO of the Prudential Huntoon Paige Associates Ltd. Were actively involved in the efforts to monitor and turnaround the property. This level of involvement and accountability is unique and a best practice.

Comment 1

II. THE PROPOSED OIG FINDING THAT PHP DID NOT UNDERWRITE AND PROCESS A $22.8 MILLION LOAN IN ACCORDANCE WITH HUD REQUIREMENTS IS WRONG

As set forth above, the OIG's failure to consider the correct provisions of the MAP Guide demonstrates that the Draft Report is unreliable and should be withdrawn. Further consideration of the OIG's specific allegations also demonstrates that the Draft Report is unreliable and should be withdrawn.

Comment 5

A. The PCNA report was complete and accurate

As noted above, the MAP Guide does not require MAP underwriters to be appraisers, engineers or cost estimators. The MAP Guide requires the MAP lender to engage professionals with those credentials and HUD approval must be granted for the MAP lender to engage their services. In that regard, PHP engaged Dominion Due Diligence Group ("Dominion"), a firm with credentialed specialists approved by HUD and widely engaged by HUD, Fannie Mae, and Freddie Mac approved lenders to perform MAP Guide required PCNAs. The team included a builder with over fifteen years of experience who had significant training, including but not limited to MAP Due Diligence Training. The team also included a professional engineer with eight years of experience in the construction industry as a structural engineer. That individual also attended MAP and HUD cost certification training. Both individuals were more than qualified to perform the PCNA. Accordingly, PHP had the right to rely on Dominion's PIR. Moreover, as discussed below, the increase in the repair numbers in the 2010 PCNA was not the

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result of a faulty PCNA, but was the direct result of the borrower's failure to complete all of the critical and non-critical repairs in accordance with the requirements set forth in the 2009 report, and the borrower's failure to complete routine maintenance at the Project.

Comment 5

Dominion conducted the first inspection of Lafayette Towers on January 8 - 9, 2009. The second inspection conducted by Dominion was on July 27 - 28, 2010, more that eighteen (18) months after the first inspection. As is now known by PHP and HUD, the borrower, without notification to or approval from HUD or PHP, fired the Management Agent ("PMR") shortly after closing and directed all project income to deposited into a non-project account. Repairs were not made during that time-frame. As a result, Lafayette Towers' physical condition deteriorated in the eighteen months between the two PCNA reports.

In addition, at the time of the first Dominion inspection, water damage to walls was identified in the PCNA. Dominion informed HUD that the water damage noted by Dominion was explained by on-site maintenance personnel to result from inadequate caulking/ sealing in unit bathroom tubs and showers. When the second inspection was conducted, repairs to the unit bathroom tubs and showers had been completed; however, evidence of additional water intrusion into walls was still in evidence. Dominion determined that the original explanation given by on-site personnel during the first inspection was likely not the only reason for the water intrusion. Thus, Dominion recommended, as a critical repair in the second inspection, that a licensed plumbing contractor evaluate the galvanized water supply pipe to determine the source of water leakage. It is important to note that the subject loan was underwritten, approved by HUD and closed in 2009, prior to HUD's issuance of new PCNA guidelines that required intrusive testing.

Comment 5

HUD did express its opinion to Dominion that "the additional repairs and increase in the required reserves listed in the latest report cannot be fully explained solely by natural deterioration of the building". However, the deterioration in the Lafayette Towers buildings was not natural. All buildings require routine maintenance and if maintenance is withheld or lacking, the physical condition of any building will deteriorate. The second PCNA specifically notes that previously identified items had not been addressed.[6]

Comment 5

The Draft Report also suggests that the PCNA inspectors must not have inspected enough units because the first report identified only two electric receptacles in the bathroom that needed replacement while the second report noted that almost 50% of the receptacles needed to be replaced. The OIG is wrong. During its first inspection, Dominion inspected 100 of the 584 units in Lafayette Towers. Only two of those units had receptacle problems identified.

[6] PHP notes that referral to the 2010 PCNA is a red herring. The 2009 PCNA should be judged based on the four corners of the 2009 PCNA report and not based on the hindsight of a report conducted one year later on a building the Borrower had (1) allowed to deteriorate; and (2) failed to repair in accordance with the 2009 PCNA.

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Dominion's conclusions, therefore, were reasonable and PHP correctly relied on those conclusions.

Comment 6

B. PHP adequately assessed the eligibility of the mortgagor and its principal prior to approving them for an FHA mortgage

The OIG is incorrect that there was more than one principal in Zulu 117, LLC. The documents provided by the borrower stated that [redacted] was the 100% member of Zulu 117, LLC. At no time during the processing, underwriting, submission of the Firm Commitment application documents, or HUD approval was there any other "member" with an interest in Zulu 117, LLC. The initial Limited Liability Company Operating Agreement of Zulu 117, LLC states in Section 4. as follows:

> "Members. The name and the business mailing address of the Members are as follows:
>
> | Name | Address |
> | --- | --- |
> | [redacted] | c/o Northern Group Inc.
575 Lexington Avenue, Suite 3200
New York, New York 10022" |

There were no amendments or changes to the Limited Liability Company Operating Agreement of Zulu 117, LLC during the processing, underwriting or the submission of the Firm Commitment application documentation to HUD.

With respect to experience, [redacted] resume reported that she had been involved in the development of retail strip centers in Kansas City, the development and management of loft buildings in New York and Philadelphia, the development of multifamily properties in Manhattan; the ownership of high-rise office buildings that involved lease-up, capital improvement programs and tenant retention; and the repositioning of Lafayette Towers apartments. In addition, [redacted] stated that over the past 20 years she had held an interest in over 5,000 multifamily units and 5MM square feet of office space. The resume also stated that she actively consulted on projects held by her son.

With respect to [redacted] creditworthiness, there was one medical account that was reported as a collection with a zero balance and another account for attorney's fees with a balance of $250. [redacted] provided a letter stating that she had no knowledge of the collection. One real estate loan with a balance of $1,189,850 balance was reported as current and another was reported closed. Credit cards with Amex and Citi were reported as closed. There were no public records reported.

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The MAP Guide does not require that the borrower or its key principal must have prior HUD experience and [redacted] did not claim to have prior experience with HUD-insured properties.

The underwriter obtained a certified financial statement from [redacted] dated February 28, 2009. The certified financial statement claimed $4.5 million in liquid assets, personal property of $800,000 and real estate holdings of $62.5 million for a total of $67.8 million in assets against liabilities of $28,952,161 (all real estate loans) for a net worth of $38,858,891. There were four real estate properties owned – one was a residence in New York and the remaining three were multifamily projects, including Lafayette Towers.

The underwriter obtained an RMCR Credit Report from Equifax on [redacted] She was reported to be employed by Zulu 117, located in New York City.

The underwriter obtained a statement of Other Business Concerns from [redacted] who reported no Other Business Concerns for Zulu 117 LLC and two Other Business Concerns for [redacted] individually (Zulu 117 and Aurora Louisville). The underwriter obtained business Credit Reports from Equifax for both Zulu 117 and Aurora Louisville and no derogatory credits or public records were reported for either entity. In addition, PHP obtained a Verification of Deposit for the borrowing entity – Zulu 117, LLC, which verified $292,772.83 on deposit.

PHP performed all due diligence required under the MAP Guide in qualifying Zulu 117, LLC and [redacted] as the key principal for the proposed loan.

Comment 7

C. PHP adequately assessed the property's financial history.

PHP obtained obtain three years of historical operating information for Lafayette Towers from the borrower. The information provided to PHP, however, was not as detailed as the information typically provided to the lender when the project has been owned by the same borrower for at least three years. As a result, in a letter dated April 16, 2009, HUD requested that the PHP underwriter provide, "the last three fiscal years financial statements on the facility". The underwriter responded in a letter to HUD on May 8, 2009 stating, "As discussed in the Firm Application narrative the property was purchased in February of 2008. A complete financial history could not be provided as the prior property management firm is no longer employed by the new owner, however, the borrower provided a three [year] financial history which was included as part of their original purchase transaction. This information was included in TAB 29" of the Firm Commitment application package submitted to HUD. There was no further inquiry on this issue from HUD and HUD accepted the information provided.

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Comment 8

D. The appraisal report was adequate

As noted above, the appraisal for the Lafayette project was conducted by an appraiser specifically approved by HUD. HUD conducted a technical review of the appraisal and concluded that the appraisal complied with the requirements of the MAP Guide and USPAP.

CohnzReznick, in its LQMD report, concluded that the appraisal complied with the requirements of the MAP Guide and USPAP. In the face of all those conclusions, the OIG's Draft Report identifies several perceived errors. None of the OIG's findings are supported by the record. For example, the OIG contends that the appraiser failed to define the term "market value" in the appraisal report. The OIG fails to explain how this alleged failure had anything to do with the default. In any event, the OIG is wrong. Market value is defined and/or discussed on pages seven, eight, fifty-four, and sixty-eight of the appraisal. Those pages define and discuss how market value is calculated.

It is not reasonable to assert in May 2015 that an opinion of value concluded in 2008 by a credentialed national appraisal firm approved by lenders and multiple HUD offices across the country that was supported by comparables, historical operating information and market supported estimates of rents, expenses, occupancy rates and was based on the characteristics of the subject property and its market area could be overstated by $11 million. While it is impossible to remove the memory of an unprecedented national recession from anyone's mind, its impact cannot be used as criteria for judgment regarding the 2008 value of Lafayette Towers in 2015. The appraiser for the subject included a significant amount of data and information regarding the then current economics in the Detroit area at the time of the appraisal and consideration for the economics of the area were considered and discussed.
Lafayette Towers was never described as an "A" property and its rents were never described as being at the top of the market. Despite population and job losses in Detroit there were still households living in Detroit and the location and characteristics of Lafayette Towers attracted those households that were not necessarily impacted by job losses. Lafayette Towers was a "B" property that catered to low to middle income households and had historically enjoyed a very healthy occupancy rate of 90% to 95%. The neighborhood was 90% built out and the ratio of renters vs. owners was close to 90%. The demographics of the area and the subject at the time were at worst status quo.

The underwriter interviewed management staff and was informed that many of the tenants at Lafayette Towers worked in and around the Detroit CBD for medical and education companies - industries that were not severely impacted by the economic downturn in Detroit. While automobile manufacturing companies in Detroit were indeed the largest employers by number of jobs, Detroit's education and medical industries commanded a significant portion of the workforce and provided a supportive population for the apartment market, including Lafayette Towers.

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The appraiser's estimated market rents were supported by market data. The underwriter, to be conservative, used the then current rents per the rent roll, which were lower than the appraiser's estimated market rents, for debt service underwriting purposes. The appraisal and the underwriter's recommended rents, expenses, capitalization rate and market value were approved by HUD. The underwritten debt service coverage was 1.34x and breakeven occupancy was 81%. The loan amount was constrained, per the underwriter's HUD form 92264-A, at 80% of value.

Comment 9

COMPARABLES

The appraisal analyzed comparables appropriately. Specifically, the physical description of Comparable Sale No. 4 (as described in Reis) while not a high rise, is a two-story project that consists of townhomes and apartments (as described in Apartment Guide found on the Internet), with both types being offered for rent. PHP accepted this comparable because it was a project with apartments for lease. The greatest differences between the subject and Comparable No. 4 are the lack of elevators and the fact that Comparable No. 4 offers townhome units. That is a demographic (number of households that might pay a higher rent for a townhome configuration) issue as opposed to a reason not to consider the sale as a comparable.

The sale of Lafayette Towers Apartment by the seller to Zulu, Inc. was not used as a comparable in the appraiser's Sales Approach analysis is because it was not a comparable sale. The sale of Lafayette Towers Apartments was a 1031 exchange vs. a "market value sale" based on its income producing potential or its comparability to otherwise comparable sales. PHP agrees that the appraiser did not comment on this fact in the appraisal report and it would have been useful information. PHP and HUD were aware that the original sale was a 1031 exchange. The following statement is included on Page 8 of the appraisal report:

> **OWNERSHIP AND HISTORY OF SUBJECT**
> The Subject was sold by Zulu Inc. to Lafayette Towers on February 8, 2008. The recorded purchase price was $16,000,000. Our concluded opinion of market value of $28,600,000 is higher than the sale price. The current owner purchased the Subject with the intent of increasing rents and decreasing expenses, specifically payroll, which was over-inflated. The previous owner was not aggressive in seeking rent increases. According to the client, the subject has a number of unit upgrades to make in the next 10 years. The client believes that the low sales price reflects these repairs. Our "As Is Repaired" market value conclusion is supported by the comparable sales and is considered reasonable. We are not aware of any other transfers of the Subject within the past three years.

PHP acknowledges that the appraiser initially applied a sales comparison analysis atypical of multifamily appraisals in the appraisal report included in the Firm Commitment application submitted to HUD. PHP further acknowledges that pursuant to a request from HUD and the underwriter, the appraiser provided an Addendum Letter dated June 10, 2009, that addressed HUD's and PHP's concerns with the appraiser's methodology (the "Addendum").

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The Addendum provided a typical Sales Comparison grid applying adjustments for: property rights conveyed, financing conditions of sale, market conditions, location, site/view, design and appeal, quality of construction, condition, and size/number of units.

SALES COMPARISON (Per Addendum)

No.	Property	Sale Date	Sale Price	# of Units	Price Per Unit	Overall Rate
1	River Terrace	Dec-07	$5,332,000	179	$29,788	8.5%
2	Town Apartments	Oct-07	$6,500,000	262	$24,809	8.4%
3	Across the Park Apts.	Feb-07	$5,230,000	200	$26,150	9.6%
4	Oak Park Manor	Jun-06	$13,196,347	289	$45,662	7.2%
5	Fyfe Building Apts.	May-06	$3,150,000	184	$17,120	8.5%
	Average			223	$28,706	8.40%

Comment 10

The above chart from the Addendum was in error with respect to Comparable No. 5. The following is an amended chart correcting the number of units and the Price Per Unit for Comparable No. 5:

SALES COMPARISON (Per Addendum with correction to Comp. No. 5)

No.	Property	Sale Date	Sale Price	# of Units	Price Per Unit	Overall Rate
1	River Terrace	Dec-07	$5,332,000	179	$29,788	8.5%
2	Town Apartments	Oct-07	$6,500,000	262	$24,809	8.4%
3	Across the Park Apts.	Feb-07	$5,230,000	200	$26,150	9.6%
4	Oak Park Manor	Jun-06	$13,196,347	289	$45,662	7.2%
5	Fyfe Building Apts.	May-06	$3,150,000	65	$48,462	8.5%
	Average			**199**	**$28,705**	**8.40%**

Comment 10

The difference attributable to the appraiser's Sales Comparison following the adjustments to Comparable No. 5 results in a reduction in the average number of units from 223 to 199 and a reduction in the average Price Per Unit from $28,706 to $28,705.

The following chart removes Comparable No. 4 (Note: PHP believes Comparable Sale No. 4 was appropriate).

SALES COMPARISON (Per Addendum with deletion of Comp. No. 4 and correction to Comp. No. 5)

No.	Property	Sale Date	Sale Price	# of Units	Price Per Unit	Overall Rate
1	River Terrace	Dec-07	$5,332,000	179	$29,788	8.5%
2	Town Apartments	Oct-07	$6,500,000	262	$24,809	8.4%
3	Across the Park Apts.	Feb-07	$5,230,000	200	$26,150	9.6%
5	Fyfe Building Apts.	May-06	$3,150,000	65	$48,462	8.5%
	Average			**177**	**$32,302**	**8.40%**

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The difference attributable to the appraiser's Sales Comparison following the deletion of Comparable No. 4 and the number of units correction to Comparable No. 5 results in a reduction in the average number of units from 223 to 177 and an increase in the average Price Per Unit from $28,706 to $32,302.

Comment 10

The above demonstrates that there is no meaningful impact to the appraiser's Capitalization Rate conclusion of 8.50%, which was based on the Overall Rates of Comparables 2 and 5 due to their similarity to the subject.

The Addendum further provided the following chart:

Comparable Improved Sale Adjustment Grid

Property Name	Subject Lafayette Towers	1 River Terrace	2 Town Apartments	3 Across the Park Apartments	4 Oak Park Manor	5 Fyfe Building Apartments
Location	1301 Orleans St.	7700 Jefferson Ave. East	1511 1st Street	2700 S. Annabelle St.	13600 Kenwood St.	10 W. Adams Av.
City, State	Detroit, MI	Detroit, MI	Detroit, MI	Detroit, MI	Detroit, MI	Detroit, MI
Comparable Data						
Year Built	1964	1939	1928	1979	1950	1919/1980
Size of Site (SF)	429,502	356,756	40,946	N/Av	958,320	4,792
Size (Acres)	9.86	8.19	0.94	N/Av	22.00	0.11
Units	584	179	262	200	289	184
Sales Data						
Date		Dec-07	Oct-07	Feb-07	Jun-06	May-06
Interest [Conveyed]	Fee Simple	Fee Simple	Fee Simple	Fee Simple	Fee Simple	Fee Simple
Price		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Price per Unit		$29,788	$24,809	$26,150	$45,662	$17,120
Adjustments						
Property Rights		0	0	0	0	0
		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Financing		0	0	0	0	0
		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Conditions of Sale		0	0	0	0	0
		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Market Conditions		1.000	1.000	1.000	1.008	1.008
Adjusted Sale Price		$5,332,000	$6,500,000	$5,230,000	$13,295,320	$3,173,625
Adjusted Price/Unit		$29,788	$24,809	$26,150	$46,005	$17,248
Adjustments						
Location		0.0%	-5.0%	5.0%	5.0%	-5.0%
Site/View		5.0%	0.0%	0.0%	5.0%	0.0%
Design & Appeal		50.0%	50.0%	50.0%	0.0%	50.0%

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Quality of Const.		0.0%	0.0%	0.0%	0.0%	0.0%
Age & Condition		10.0%	10.0%	0.0%	0.0%	0.0%
Size		0.0%	0.0%	0.0%	0.0%	0.0%
Overall Adjustment		65.0%	55.0%	55.0%	10.0%	45.0%
Adjusted Price/Unit		$49,150	$38,454	$40,533	$50,605	$25,010
Low	$25,010					
High	$50,605					
Mean	$40,750					
Median	$40,533					
Conclusion	$45,000	X	584	$26,280,000		
Rounded				**$26,300,000**		

The following chart corrects Comparable No. 5 with respect to the number of units:

Amended Comparable Improved Sale Adjustment Grid

	Subject	1	2	3	4	5
Property Name	Lafayette Towers	River Terrace	Town Apartments	Across the Park Apartments	Oak Park Manor	Fyfe Building Apartments
Location	1301 Orleans St.	7700 Jefferson Ave. East	1511 1st Street	2700 S. Annabelle St.	13600 Kenwood St.	10 W. Adams Av.
City, State	Detroit, MI	Detroit, MI	Detroit, MI	Detroit, MI	Detroit, MI	Detroit, MI
Comparable Data						
Year Built	1964	1939	1928	1979	1950	1919/1980
Size of Site (SF)	429,502	356,756	40,946	N/Av	958,320	4,792
Size (Acres)	9.86	8.19	0.94	N/Av	22.00	0.11
Units	584	179	262	200	289	65
Sales Data						
Date		Dec-07	Oct-07	Feb-07	Jun-06	May-06
Interest [Conveyed]	Fee Simple	Fee Simple	Fee Simple	Fee Simple	Fee Simple	Fee Simple
Price		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Price per Unit		$29,788	$24,809	$26,150	$45,662	$48,462
Adjustments						
Property Rights		0	0	0	0	0
		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Financing		0	0	0	0	0
		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Conditions of Sale		0	0	0	0	0
		$5,332,000	$6,500,000	$5,230,000	$13,196,347	$3,150,000
Market Conditions		1.000	1.000	1.000	1.008	1.008
Adjusted Sale Price		$5,332,000	$6,500,000	$5,230,000	$13,295,320	$3,173,625
Adjusted		$29,788	$24,809	$26,150	$46,005	$48,825

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Price/Unit Adjustments						
Location		0.0%	-5.0%	5.0%	5.0%	-5.0%
Site/View		5.0%	0.0%	0.0%	5.0%	0.0%
Design & Appeal		50.0%	50.0%	50.0%	0.0%	0.0%
Quality of Const.		0.0%	0.0%	0.0%	0.0%	0.0%
Age & Condition		10.0%	10.0%	0.0%	0.0%	0.0%
Size		0.0%	0.0%	0.0%	0.0%	0.0%
Overall Adjustment		65.0%	55.0%	55.0%	10.0%	45.0%
Adjusted Price/Unit		$49,150	$38,454	$40,533	$50,605	$46,384
Low	$38,454					
High	$50,605					
Mean	$45,025					
Median	$40,533					
Conclusion	$45,000	X	584	$26,280,000		
Rounded				**$26,300,000**		

Comment 10

Highlights above and below are changes made to the appraiser's chart included in the Addendum for purposes of this discussion.

The corrections made by PHP to the Comparable Improved Sale Adjustment Grid include the number of Units, the Price per Unit, the Adjusted Price/Unit, and the Design & Appeal 50% adjustment to Comparable No. 5.

The appraiser's conclusion of $45,000 per unit for the subject remains valid based on the range of $38,454 to $50,605.

It is important to note that if Comparable No. 4 is removed, the only additional change to the amended chart would be to the "High" part of the range as shown below:

Low	$38,454			
High	$49,150			
Mean	$43,630			
Median	$40,533			
Conclusion	$45,000	X	584	$26,280,000
Rounded				**$26,300,000**

The appraiser's conclusion of $45,000 per unit remains valid and is supported by the range from $38,454 to $49,150 even with the removal of Comparable No. 4.
The appraisal reconciliation is as follows with the changes made in the Addendum:

Estimated Replacement Cost of Project:	$51,215,201
Income Capitalization Approach:	$28,600,000
Sales Comparison Approach	$26,300,000
Reconciled Value	$28,600,000

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Lafayette Towers Apartments is an income producing property and an investor would look to its income producing potential in the decision process. PHP and HUD agreed that the Reconciled Value at $28,600,000 was appropriate for the subject.

Comment 11

RENT ADJUSTMENTS

The rent adjustments made were appropriate. PHP reviewed the appraiser's narrative and the HUD form 92273's for the subject's studio units (2 sizes), 1 bedroom units (1 size), 2 bedroom units (2 sizes) and 3 bedroom units (2 sizes). There was only one project in the array of comparable apartment projects that offered 3 bedroom apartments and the appraiser was forced to compare the subject's 3 bedroom units to 2 bedroom units offered at the remaining comparables.

The $250 bedroom adjustment is based on the difference in the asking rent offered at the one comparable with a 3 bedroom unit. That comparable's 3-bedroom asking rent was $1,784 which the appraiser adjusted downwards $149 for concessions and $50.00 for the size differential of 900 square feet (subject was 1,500 square feet and comparable was 2,400 square feet). The adjusted asking rent of $1,585 was compared to $1,200 for Comparable No. 2's 2-bedroom units, $1,300 for Comparable No. 3's 2-bedroom units, $941 for Comparable No. 6's 2-bedroom units and $1,500 for Comparable No. 7's 2-bedroom units, a difference ranging from $644 (Comparable No. 6) to $85 (Comparable No. 7). The difference in Comparables 2 and 3's adjusted asking rent was $385 and $285 respectively. In addition, the $250 bedroom adjustment was applied in lieu of and not in addition to a square footage adjustment for each of the 2 bedroom comparables. PHP's review concluded that the $250 bedroom adjustment was supported.

PHP reviewed the HUD form 92273 and the appraiser's narrative and noted that a $10 adjustment for surface parking was applied to the comparables that offered only surface parking and included that adjustment in the asking rent. Most appraisers, particularly national firms, maintain a database of adjustments for amenities, parking, etc. The subject's ($10) adjustment was considered reasonable based on other appraisals that PHP underwriter's have reviewed and based on the reputation of the appraisal firm. In any event, it is a nominal adjustment and is made to only three of seven comparables.

PHP reviewed the HUD form 92273 and the appraiser's narrative and noted the $5 adjustment made to all of the comparables for the lack of storage, which Lafayette Towers Apartment does provide.

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PHP reviewed the HUD form 92273 and the appraiser's narrative regarding "Condition/Street Appeal" and it is PHP's view that the condition of a comparable can be easily determined by the on-site inspection conducted by the appraiser. "Street Appeal" is more subjective; however, PHP relied upon and has the right to rely upon the approved appraiser's opinion with respect to each comparables' street appeal.

Pages 40 through 44 of the appraisal included in the Firm Commitment application submitted to HUD includes a narrative addressing each of the components of the HUD form 92273's prepared by the appraiser and provides an explanation for the appraiser's adjustment conclusions.

No inconsistencies exist in the adjustments applied by the appraiser in the HUD form 92273's. The only differences found were in the dollar amounts of the per square foot adjustments which reduced the larger gap (plus or minus) between the comparables' unit and the subject. This is appropriate methodology for making adjustments for unit size differences.

Comment 12

OPERATING EXPENSES

The appraiser is charged with locating not less than three comparable properties and reporting expenses for the comparables. The appraiser is also charged with reviewing historical operating information for the subject property and comparing it to the expense comparables. The appraisal report provided the required information and the underwriter included a summary thereof in the Underwriting Narrative Summary. In the instant case, the operating expenses of four expense comparables were arrayed in HUD form 92274, Operating Expense Analysis and details of the appraisers conclusions for the subject were provided in the appraisal narrative. The expense comparables ranged in size from 94 to 208 units, all less than half of the size of the subject.

	Comparables' Range	Subject's Range	Appraiser's Conclusion	Underwriter's Conclusion
Admin/Advertising	$149 - $613	$95 - $328	$212	$294
Management Fee	3% to 6% of EGI	3% of EGI	3% of EGI	2% (1)
Utilities (2)	$643 - $904 (3)	$1,539-$2,164	$2,101	$1,734 (4)
Repairs/Maint.	$539 - $870	$710 - $867	$748	$748 (5)
Payroll	$135 - $938	$534-$2,149 (6)	$933	$933
Insurance	$210 - $408	$51 - $220	$202	$202 (7)
Real Estate Taxes	$338 - $1,382	$638	$638	$638 (8)
Replacement Resv.	N/A	N/A	$350	$350 (5)

(1) The underwriter based the management fee of 2% on the executed Management Agreement with the Management Agent. A lower than market management fee is seen frequently in large multifamily projects such as the subject with 584 units.

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(2) Prior to the sale of the subject to the borrower and thereafter, electric utilities were reimbursed to the owner through the RUBS system. The above chart reflects the total for all utilities and the tenant reimbursements are included in Other Income.

(3) The Comparables' Range is not considered to be reliable due to the differences between multifamily projects and how utilities are paid.

(4) The appraiser relied on information provided by the local housing authority in estimating the conclusion for utilities expense (the appraiser considered the housing authority's amount to be low at $1,006 per unit and increased that result to $2,101). The underwriter placed the most weight on the subject's historical utility expenses and concluded to a number below the appraisers for debt service underwriting purposes.

(5) Both the appraiser's and the underwriter's conclusion of $748 for Repairs and Maintenance was based on the fact that a Replacements Reserve Escrow would be established with the proposed loan (the subject did not have a Replacements Reserve prior to the subject loan) and replacements would be funded from the Escrow going forward.

(6) The prior owner (the seller of the subject) reportedly employed a significantly larger staff for the subject than is the market norm. Based on market data, the appraiser's conclusion, with which the underwriter concurred, assumed a 6 person full-time management staff, 6 person full-time maintenance staff, payroll taxes at 12% and benefits at $5,000 per staff member. The conclusion at $933 per unit is at the high end of the expense comparables' range but is reasonable given the number of units at more than twice the number of units of each of the expense comparables.

(7) The borrower provided an insurance quote which calculated to $52 per unit for the subject. The appraiser and the underwriter both believed that the quote was considerably below market and therefore estimated an insurance expense of $202 per unit, similar to the subject's 2007 expense.

(8) An adjustment in the Assessment was pending due to the sale of the subject. The appraiser addressed the change in the appraisal report (see below) and provided the following estimate for 2009 taxes. Please note that the sale of the subject increased the real estate taxes from $408 per unit to $638 per unit.

CURRENT ASSESSMENT

Year	Total SEV Assessment	Total Taxable Value	Millage Rate (per $1,000)	Total Taxable Value/Unit	Estimated Tax Burden	Estimated Tax Burden Per Unit
2009	$5,000,000	$5,000,000	$74.5397	$8,562	$372,699	$638
2008	$5,000,000	$3,194,844	$74.5397	$5,471	$238,143	$408

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The appraiser's concluded expenses, before Replacement Reserves was $5,122 per unit and after Replacement Reserves was $5,472 per unit per annum. The estimate was significantly higher than the range of the expense comparables ($2,563 - $4,321) and within the range of historical expenses for the subject ($3,660 in 2208 to $6,542 in 2005). As previously stated, the operating statements from the seller which included 2005 through 2007 information was very limited. It is not known if the seller included capital expenditures in the reported operating expenses during 2005 through 2007 as no detail is provided. In addition, it was reported to the appraiser and to the underwriter that the seller had completed approximately $6MM in replacements and improvements prior to the sale and therefore, it was logical to accept that Repairs and Maintenance would be less in the following years. The appraiser's concluded $5,472 per unit per annum represented 92.3% of the seller's reported $5,930 per unit in 2007.

Comment 12

To determine the impact of applying the OIG's $5,604 per unit operating expenses, PHP calculated that the Debt Service Coverage would have been reduced from 1.32 to 1.31 based on the Note interest rate of 5.35%.

PHP and HUD accepted the appraiser's conclusion of expenses for valuation purposes. The underwriter's conclusion for debt service underwriting purposes was lower due to the underwriter basing rents on the then current rent roll (vs. the appraiser's market supported rents) which were lower than market and which impacted the expenses that were based on a percentage of EGI, and the underwriter's reliance on the subject's historical utilities expense vs. the appraiser's estimate.

At the time of the appraisal and the underwriting of the Lafayette Towers loan, the subject had enjoyed a historical occupancy rate of 90 to 95%, demonstrating that stressed financial times and a high unemployment period had not placed a heavy burden on the subject's occupancy. As per the appraisal and the underwriter's interviews with on-site personnel conducted during the underwriter's site visit, Lafayette Towers attracted young professionals in industries not necessarily impacted by the downturn in the automobile industry in Detroit. The reason for the immediate and significant reduction in occupancy at Lafayette Towers following the closing of the subject loan was not attributable to stressed financial times and high unemployment. It was the direct result of Alex Dembitzer's actions following the closing of the loan.

CAPITALIZATION RATE

Comment 13

PHP strongly disputes the OIG's Capitalization Rate of 9.9 for the subject in January of 2009. The five comparable sales reported Overall Rates of 8.5, 8.4, 9.6, 7.2 and 8.5, averaging 8.4. It is not reasonable to impose a higher rate in 2015, more than 6 years after the date of the appraisal, based on factors not in place at the time of the appraisal. In addition to the sales comparables, the appraiser relied on:

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- Korpacz National Apartment Market Survey which demonstrated that the national multifamily housing market's Capitalization Rates had not breached 8.5 from 1st Quarter 2003 through 3rd Quarter 2008 (range was 3.8 to 8.5, averaging 6.13).

- Debt Coverage Ratio technique which applied an Overall Rate of 8.98% = a Debt Coverage Ratio of 1.3 x a Mortgage Constant of 0.0864 x an 80% Loan to Value Ratio. The source of the data was Bloomberg.com as of February 2009.

- Band of Investment technique applied an Overall Rate of 8.71%, a Loan to Value Ratio of 80% x a Mortgage Constant of 0.0864 ÷ 20% x a 9.00% Equity Dividend. The source of the data was Bloomberg.com as of February 2009.

The appraiser's conclusions were summarized as follows:

Market Extraction	8.50%
Korpacz Survey	8.00%
Debt Coverage Ratio	8.98%
Band of Investment	8.71%
Reconciled Capitalization Rate	8.50%

The above is a relatively tight range that is well below the OIG's 9.9% rate. The data provided by the appraiser from these four sources to arrive at an 8.5% Capitalization Rate was determined from three sources outside of the appraiser's control and in addition to a reasonable analysis of the comparable sales.

The above analysis demonstrates that the appraiser appropriately analyzed the subject and the PHP's underwriter thoroughly reviewed the appraisal and made appropriate adjustments in underwriting the Lafayette Towers loan. The OIG's allegations that PHP did not adequately review the appraisal, therefore, are unsupported and unfounded.

III. Conclusion

Every loan entails some risk of default. The purpose of the MAP Guide is to outline the level of risk that HUD is willing to assume and to provide guidance for a lender to gather, analyze and supply relevant information to HUD. The lender submits the firm commitment application, including a full underwriting package, to HUD to determine whether the loan is an acceptable risk. If HUD determines that the project meets program requirements, it issues a firm commitment to the lender for mortgage insurance.

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HUD, in this case, reviewed all the information provided and concluded that the information complied with all program requirements. HUD also concluded that the risk was acceptable and issued a firm commitment. Those judgments, exercised, at the time the Loan was underwritten, demonstrate that PHP complied with its obligations.

PHP disputes the conclusion that it did not underwrite the Lafayette Towers Apartments loan in accordance with applicable guidelines and regulations. PHP underwrote the Lafayette Towers loan in compliance with all HUD requirements as is evidenced by the fact that the loan was approved by HUD.

Without anecdotal evidence to negate otherwise documented evidence of a borrower's business practices, it is impossible to underwrite a borrower's intent to violate the terms of the loan documents. There is no doubt that the failure of Lafayette Towers to perform pursuant to the loan documents was due to the actions of the borrower. None of the issues addressed above regarding the appraisal, the PCNA or PHP's mortgage credit investigation and conclusions provoked or caused the borrower to default on the loan.

What occurred at Lafayette Towers Apartments is a tragedy. It is a historical building in a historical area and it should not have been treated physically or financially the way the borrower treated it nor should it have suffered the reputational downturn caused by the borrower.

Sincerely,

Constantinos G. Panagopoulos

OIG Evaluation of Auditee Comments

Comment 1	Prudential's outside attorney's comments state that we ignored the requirements of the MAP Guide and improperly substituted its own judgment as to how the Lafayette Towers loan should have been underwritten. Prudential outside attorneys also state that we failed to consider the MAP Guide in relation to its audit objective and believes that Prudential should have second guessed the conclusions in the appraisal and the project capital needs assessment. In addition, Prudential's comments included extensive criteria for HUD's responsibilities in the underwriting process.

We applied criteria from the MAP Guide to review the lender's conclusions versus what the requirements state. We also conducted the audit in accordance with generally accepted government auditing standards. Prudential has specific responsibilities, such as conducting a sufficient review of all loan documents submitted to HUD for review, which we determined did not occur. Although HUD approved the loan, Prudential was responsible for reviewing the documents to ensure compliance with the requirements and that the loan presented an acceptable risk, which it did not. The MAP Guide, revised in 2002, paragraph 15-1(A), states that HUD places confidence in the lender's integrity and competence, thus relying on the documents provided by Prudential. The audit objective was to determine whether the loan was underwritten and processed in accordance with HUD guidelines, including but not limited to the MAP Guide. The report cites all applicable requirements to support the findings in the footnotes and the narrative.

We did not conclude that Prudential should have second guessed the appraiser and the project capital needs assessment engineer. Instead, we concluded that Prudential was required to conduct a review of the appraisal and the project capital needs assessment reports to ensure compliance with the MAP Guide and applicable USPAP requirements. Our review determined that the appraisal and project capital needs assessment submitted to HUD did not comply with the requirements and did not include the information required. In addition to the criteria cited in the report, the MAP Guide, revised in 2002, paragraph 1-4(C)(5), states that for the firm commitment application, the lender performs a complete underwriting of the application, including an architecture review, a cost review, and a review of the appraisal. Further, Prudential certified that third-party reports, including the appraisal and the project capital needs assessment, were reviewed to ensure compliance with requirements and that they were accurate and complete. Prudential should have conducted a review sufficient to certify that the third-party reports complied. Paragraph 7-9(B) also lists the responsibilities of the lender.

Comment 2	Prudential's outside attorney's comments state that HUD certified to the accuracy and appropriateness of the judgments that we cite as evidence that Prudential did not properly underwrite the loan. However, Prudential had the responsibility to conduct a review before submitting the loan to HUD, including certifying that the loan was in accordance with HUD guidelines and presented an acceptable risk to HUD, which it did not. See comment 1 above.
Comment 3	Prudential's outside attorney's comments state that an independent reviewer concluded that Prudential complied with the MAP Guide requirements while underwriting the loan for Lafayette Towers. Prudential outside attorney's also state that the independent reviewer generally satisfied the reporting requirements of the MAP Guide and the USPAP standards. However, we reviewed the independent reviewer's report as part of the audit and noted its conclusions in the audit report as they related to the objective and findings. The audit considered the independent reviewer's report; however, assessing the accuracy and completeness of the independent reviewer's report was not the audit's objective.
Comment 4	Prudential's outside attorney's comments state that we failed to consider a number of factors that led to the Lafayette default. Prudential's outside attorney's also state that, overall, it appeared that the unexpectedly high vacancy rate at the property was caused by multiple factors, including the misappropriation of funds, deteriorating property conditions as a result of incomplete construction and deferred maintenance, and inadequate property management. We acknowledge that the default was caused by those factors. However, we also determined that Prudential's failure to properly underwrite and process the loan was directly connected to those factors. Specifically, OIG determined that Prudential's (1) inadequate review of the project capital needs assessment contributed to the incomplete construction and (2) inadequate review of the principals' eligibility resulted in the approval of principals that misappropriated project funds and inappropriately took over the property's management function without notifying HUD.
Comment 5	Prudential's outside attorney's comments state that the project capital needs assessment was complete and accurate. Prudential's outside attorney's also state that it was known by Prudential and HUD, that the borrower, fired the management agent after closing and directed all project income to be deposited into a nonproject account without notification to or approval from HUD or Prudential. Repairs were not made during that timeframe. As a result, Lafayette Towers' physical condition deteriorated in the 18 months between the two project capital needs assessments.

We acknowledge that the borrower inappropriately diverted project funds. However, we also determined that Prudential's failure to adequately assess the borrower and its principals resulted in the approval of an inappropriate borrower, which misappropriated project funds and inappropriately took over the property's management function without notifying HUD.

In addition, Prudential outside attorney's state that HUD expressed its opinion to Dominion that "the additional repairs and increase in the required reserves listed in the latest report cannot be fully explained solely by natural deterioration of the building." However, the deterioration in the Lafayette Towers buildings was not natural. All buildings require routine maintenance and if maintenance is withheld or lacking, the physical condition of any building will deteriorate.

We acknowledge that some of the repairs could have resulted from inadequate maintenance; however, some of the repairs did not occur as a result of poor maintenance.

Further, Prudential's outside attorney's comments state that the report also suggests that the project capital needs assessment inspectors must not have inspected enough units because the first report identified only two electric receptacles in the bathroom that needed replacement, while the second report noted that almost 50 percent of the receptacles needed to be replaced. During its first inspection, Dominion inspected 100 of the 584 units in Lafayette Towers. Only two of those units had receptacle problems identified. Dominion's conclusions, therefore, were reasonable, and Prudential correctly relied on those conclusions.

Appendix 5M of the MAP Guide provides that lenders are required to determine whether an adequate sampling of units has been made. It also provides that the needs assessor must inspect enough dwelling units to be able to formulate an accurate estimate of repair, replacement, and major maintenance needs. We determined that the initial needs assessment sampled only 100 of 584 units, or 17 percent, and the second needs assessment sampled 205 of 584 units, or 35 percent. The initial needs assessment identified an issue with the receptacles in only 2 of the units, or 2 percent; however, the second report required the same repair for 292 units, or 50 percent of the project. The initial needs assessment included the critical repair to install ground fault circuit receptacles in kitchens and bathrooms. This item involved ungrounded outlets in the walls of all of the bathrooms. The needs assessment also included the need for critical repairs to remove or disconnect receptacles in bathroom lighting fixtures in apartments E1813 and E2203 (the two units in question). This item involved ungrounded outlets in the bathroom lighting fixtures.

We determined that it was unreasonable for the needs assessment to require this repair for only two units, considering that the initial needs assessment required bathroom wall receptacles to be replaced with a ground fault circuit interrupter. It would have been prudent for the needs assessment to require the electrician to check all lighting fixture (medicine cabinet) receptacles while physically in the bathrooms and disconnect or remove them while on site. The needs assessment should have required the repair of all of the units, considering that it was a shocking hazard and both of the faulty grounds were within a close distance within the same room.

Comment 6

Prudential's outside attorney's comments state that it adequately assessed the eligibility of the borrower and its principal before approving them for the FHA mortgage. Prudential outside attorney's state that we are incorrect in stating that there was more than one principal in Zulu 117, LLC, as the documents provided by the borrower stated that the principal was the 100 percent member of Zulu 117, LLC. Prudential's outside attorney's comments include details about the borrower's experience, creditworthiness, and financial statements.

We considered the details provided and determined that they were also outlined in the underwriter narrative submitted to HUD for review. However, the additional details did not comply with MAP Guide, paragraph 8-3(J), which provides that the lender's underwriter is to evaluate the resume of the principal(s) and in doing so, the underwriter will look for its experience in developing, owning, or building similar multifamily properties. The criteria also require lenders to pay particular attention to (1) type and size of previous projects, (2) geographic area of business involvement, (3) length of time served in this capacity, and (4) past roles in multifamily business. Prudential did not adequately outline principal A's multifamily experience, did not address the type and size of the multifamily developments in which she had experience, and did not specify her role in the property developments and how long she had served in the unstated capacity.

We acknowledged that the borrower had one member with an interest in the company. However, we determined that the borrower had two additional principals whose eligibility was not assessed by Prudential. The MAP Guide, paragraph 8-3(D)(1)(a)(1), provides that principals of the borrower include all operating officers of the corporation. OIG determined that these additional principals were operating officers within the company. Specifically, the borrower's limited liability corporation documents showed that principals A and B were managing members. The limited liability documents showed that principal C was the chief financial officer of the company.

Comment 7 Prudential's outside attorney's comments state that it adequately assessed the property's financial history. Prudential also states that it obtained 3 years of historical operating information for Lafayette Towers from the borrower. Prudential outside attorney's add that a complete financial history could not be provided as the prior property management firm is no longer employed by the new owner; however, the borrower provided a 3-year financial history, which was included as part of its original purchase transaction.

We acknowledge that Prudential provided the property's 3-year financial history. However, the financial records did not fully comply with MAP requirements because Prudential did not provide the required financial statements for the previous 3 years. Instead, it provided only a comparative operating statement for 2005 through 2007.

Further, Prudential outside attorney's state that a complete financial history could not be provided as the prior property management firm is no longer employed by the new owner; however, the borrower provided a 3-year financial history, which was included as part of its original purchase transaction.

The MAP Guide acknowledges that there may be circumstances beyond the borrower's control under which the financial statements cannot be obtained. In these instances, the MAP Guide provides that the borrower must submit evidence satisfactory to the lender that the financial statements were not obtainable. The MAP Guide provides that the lender's case file must contain (1) a written statement by the borrower explaining why the records were not obtainable and (2) a memorandum from the lender stating that it evaluated the borrower's statement and agreed that the information was unattainable. Prudential's files did not include the required documentation.

Comment 8 Prudential's outside attorney's comments state that the appraisal report was adequate. Prudential's outside attorney's further state that the appraisal for the Lafayette project was conducted by an appraiser specifically approved by HUD and that HUD conducted a technical review of the appraisal and concluded that the appraisal complied with the requirements of the MAP Guide and USPAP. In addition, Prudential states that none of our findings are supported by the record. For example, we state that the appraiser failed to define the term "market value" in the appraisal report. Prudential's outside attorney's added that we fail to explain how this alleged failure had anything to do with the default. In any event, OIG is wrong. Market value is defined and discussed on pages 7, 8, 54, and 68 of the appraisal. Those pages define and discuss how market value is calculated.

The audit report documented the MAP and USPAP requirements that Prudential did not comply with while conducting its review of the appraisal. Although the appraisal is a professional opinion, it must be supported and include verifiable information, which Prudential's appraisal did not. The land value concluded by us is supported with information that was available to Prudential's appraiser at the time the appraisal was conducted. Further, the audit report did not state that Prudential failed to define the term "market value" in the appraisal report.

Comment 9

Prudential's outside attorney's comments state that the appraisal analyzed the comparables appropriately. Prudential's outside attorney's state that the sale of Lafayette Towers Apartments by the seller to Zulu, Inc., was not used as a comparable in the appraiser's sales approach analysis because it was not a comparable sale. It adds that the sale of Lafayette Towers Apartments was a 1031 exchange versus a "market value sale" based on its income-producing potential or its comparability to otherwise comparable sales.

USPAP Standard Rule 1-5 provides that when the value conclusion to be developed is market value, an appraiser must, if such information is available to the appraiser in the normal course of business, omit or analyze all sales of the subject property that occurred within the 3 years before the effective date of the appraisal. Just stating that it was a 1031 exchange does not provide evidence that the sale was not market value and should not have been considered as a comparable sale. We determined that the previous sale of Lafayette Towers was on a per unit basis at a sale price that fell in the mid-range of three of the comparable sales that the appraiser used in the market data approach. If the appraiser had analyzed the Lafayette Towers sale, dated April 22, 2008, a different value conclusion would have been reached.

Further, Prudential's outside attorneys agree that the appraiser did not comment on this fact in the appraisal report and it would have been useful information. Prudential and HUD were aware that the original sale was a 1031 exchange.

We determined that the sale was comparable and was previously sold at market value. We also noted that the borrower outbid seven other offers by $2 million.

Comment 10

Prudential's outside attorney's comments state that the sales comparison addendum included an error with respect to comparable number 5 and indicated that there was no meaningful impact to the value conclusion.

We acknowledge that the error in comparable 5 alone would not significantly affect the value of the property. However, when all of the issues identified in the appraisal were considered in conjunction with each other, the value of the property was significantly overstated. The appraisal deficiencies included inappropriate comparable sales, inappropriate market data adjustments, unreasonable operating expenses, and unsupported capitalization rates.

Based on the adjustments Prudential made in the chart on page 21 of its comments, we determined that Prudential attempted to correct issues related to the appraiser's misinformation on the number of units (184 units versus 65 units) for comparable sale number 5 and correct the sales comparison grid to support the value conclusion. We questioned whether the comparable sales were appropriate and accurate and concluded that the adjustments made in the sales comparison approach were not meaningful and supported. Specifically, the appraiser made 50 percent adjustments for design and appeal to four of the five comparable sales without reliable analysis or support for the conclusion. Prudential failed to provide additional support for these adjustments. USPAP Standard Rule 2-2(a)(vii) requires the appraiser to describe the information analyzed; the appraisal methods and techniques employed; and the reasoning that supports the analysis, opinions, and conclusions. Standard Rule 2-2 further states that the appraiser must provide sufficient information to enable the client and intended users to understand the rationale for the opinions and conclusions, including reconciliation of the data and approaches.

Comment 11

Prudential's outside attorney's comments state that the rent adjustments made were appropriate.

We did not question the validity of the appraiser's rent adjustments. Specifically, the audit report discussed only the following appraisal deficiencies: (1) inappropriate comparable sales, (2) inappropriate market data adjustments, (3) unreasonable operating expenses, and (4) unsupported capitalization rates.

Comment 12

Prudential's outside attorney's comments state that the appraisal report provided the required information and the underwriter included a summary. Prudential's outside attorney's also states that to determine the impact of applying OIG's $5,604 per unit operating expenses, Prudential calculated that the debt service coverage would have been reduced from 1.32 to 1.31 percent based on the note interest rate of 5.35 percent.

We acknowledge that the difference in the expenses alone would not significantly affect the value of the property. However, when all of the issues identified in the appraisal were considered in conjunction with each other, the value of the property was significantly overstated. The appraisal deficiencies included inappropriate comparable sales, inappropriate market data adjustments, unreasonable operating expenses, and unsupported capitalization rates. Prudential's appraiser determined that the value was $28.6 million. Based on information available at the time of Prudential's appraiser review, we recalculated the value to be $17.5 million, more than $11 million less than Prudential's appraised value.

Comment 13

Prudential's outside attorney's comments state that it strongly disputes OIG's capitalization rate of 9.9 percent for the subject property in January 2009. Prudential's outside attorney's also state that the five comparable sales reported overall rates of 8.5, 8.4, 9.6, 7.2, and 8.5 percent, averaging 8.4 percent. Further, Prudential's outside attorney's state that it was not reasonable to impose a higher rate in 2015, more than 6 years after the date of the appraisal, based on factors not in place at the time of the appraisal. It concludes that OIG's allegations that Prudential did not adequately review the appraisal are unsupported and unfounded.

We reviewed the market abstraction of capitalization rates stated by the appraiser and determined that the income and expenses related to the comparable sales were not supported. The appraiser assumed an operating expense of $4,500 per unit for each of the comparable sales, and comparable sale number 5 had an income based on the incorrect number of units. Therefore, the capitalization rates derived were not supported. We determined a capitalization rate of 9.9 percent. Lafayette Towers sold for $16 million in April 2008, and according to income and expense reports, the complex had a net operating income of more than $1.58 million, which yielded a capitalization rate of 9.9 percent.

Further, while the Korpacz Survey might indicate a different capitalization rate according to the appraiser, the Korpacz is based on a national multifamily market and not on the Detroit market. As noted in the appraisal report and Prudential's response, the Detroit market was in an extreme economic downturn in 2008 and 2009, and it would be expected that a capitalization rate for a property in mid-town Detroit would be higher than in other parts of the country.

Appendix C

Schedule of Borrower's Principal's Liens

Filing type	Original filing date	Amount	Debtor(s)	Comments
Judgments docket	March 13, 2007	$843	Company of which principal B was principal & managing member[17]	Lien filed before firm commitment date and loan closing with no release date
Civil new filing	August 11, 2006	$16,248	Company of which principal B was principal & managing member	Lien filed before firm commitment date and loan closing with no release date
Small claims judgment	December 5, 2005	$8,000	Company of which principal B was principal & managing member	Lien filed before firm commitment date and loan closing with no release date
State tax warrant	July 19, 2008	$853	Principal B	Lien filed before firm commitment date and loan closing with no release date
Judgments docket	October 26, 2000	$5,721	Principal B	Lien filed before firm commitment date and loan closing with no release date
Judgment	December 3, 1996	$720	Principal B	Lien filed before firm commitment date and loan closing with no release date
Judgment	November 29, 1993	$1,804,635	Principal B	Lien filed before firm commitment date and loan closing with no release date
Judgments docket	July 27, 1993	$17,468	Principal B	Lien filed before firm commitment date and loan closing with no release date
Civil new filing	October 5, 1992	$526,415	Principal B	Lien filed before firm commitment date and loan closing with no release date
Civil suit	March 1,1991	$98,364	Principal B	Lien filed before firm commitment date and loan closing with no release date
Judgments docket	March 29,1989	$3,279	Principal B	Lien filed before firm commitment date and loan closing with no release date
Total		**$2,482,546**		

[17] We determined that the borrower and the above-referenced company had the same address.

Appendix D

Schedule of Critical Repairs Contributing to Property Deterioration

2010 critical need repairs	Total	Listed in 2009 project capital needs assessment
1. Install 7 designated handicap parking spaces & add access aisles at the current 6 handicap parking spaces.	$1,950	yes
2. Install 2 cross paths from handicap parking spaces to buildings.	$500	yes
3. Install HUD-compliant smoke detectors in hallways and bedrooms.	$4,095	yes
4. Install ground fault circuit receptacles in kitchens.	$20,440	yes
5. Replace or disconnect receptacle located within the entry foyer of the west building.	Complete	yes
6. Replace missing light fixtures globe in hallway of dwelling unit 1302-W.	Complete	yes
7. Remove or disconnect receptacle in bathroom lighting fixtures in dwelling units 1813-E & 2203-E.	$14,600	yes
8. Abate friable asbestos-containing materials in parking deck area.	$10,000	yes
9. Implement an asbestos operation and maintenance plan.	$500	yes
10. Repair 11th floor "B" stairway door of the east building that is not operating properly.	$100	no
11. Repair improperly working emergency lighting in stairways and hallways.	$1,600	no
12. Repair loose door hardware on stairway doors.	No cost	no
13. Replace damaged outlet in common hallway outside dwelling unit 303-E.	$35	no
14. Install self-closing hinges on dwelling units' doors.	$29,200	no
15. Install National Fire Protection Association-approved exit lighting at stairway doors	$32,200	no
16. Drain water from fire hose in 12th floor stairway.	No cost	no
17. Cover exposed electrical wires at junction box at parking deck	$75	no
18. Have a licensed plumbing contractor evaluate the galvanized water supply pipe.	$10,000	no
19. Complete correction of all violations noted on building inspection.	Pending	no
Total	**$125,295**	

Appendix E

Schedule of Noncritical Repairs Contributing to Property Deterioration

2010 noncritical repairs	Total	Comments
1. Repair damaged plaster in hallways.	No cost	Completed*
2. Repair-regrout bathroom and shower ceramic tile.	No cost	Completed*
3. Replace door in hallway of dwelling unit 1302-W.	$225	Repair incomplete
4. Replace exit door onto the roof of the east building.	$275	Repair incomplete
5. Repair damaged brick on the north side of the west staircase in the covered parking deck.	No Cost	Repair incomplete
6. Repoint brick on south side of the west stair within the parking deck.	No Cost	Repair incomplete
7. Repair damaged concrete located at the entrance into the covered parking deck and the service entrance of the west building.	Complete	Completed
8. Repair damaged concrete steps on west stair case located in parking deck.	Complete	Completed
9. Repair damaged guard rail at exterior patios.	Pending	Repair Inadequate**
10. Repair spalling concrete on sidewalks.	Complete	Completed
11. Repair plaster ceiling located within community room in the west building.	Complete	Completed
12. Repair asphalt parking area located on the north side of the property.	$1,326	Repair incomplete
13. Complete renovation of elevators.	Complete	Completed
	$1,826	
14. Refurbish parking garage, including exterior brick wall, concrete rooftop, structural columns, walls, bricks, and concrete staircase.	$205,800	New work item
15. Replace air handler units in east and west buildings.	$89,460	New work item
16. Replace rooftop make-up air units.	$50,554	New work item
17. Identify ground water condition and repair sink holes in parking lot.	Pending	New work item
18. Replace damaged exterior concrete patios at north ends of east and west buildings.	$12,000	New work item
19. Perform plumbing repairs based on the recommendations of plumbing evaluation noted in critical repairs.	Pending	New work item
20. Replace dwelling entry units 303W, 1609E, 1704E, and 313W.	$1,180	New work item
21. Replace dwelling entry locks on select units.	$1,500	New work item
22. Repair leaking butterfly valves on boilers as noted.	$9,600	New work item
23. Repair or replace cracked shower pans in dwelling units.	$146,000	New work item
24. Replace master bath shower doors.	$40,000	New work item
25. Replace roofs on east and west building.	$278,408	New work item
26. Return down units to rentable condition.	$224,000	New work item
27. Repair spalling concrete at select areas of parking deck.	$8,000	New work item
	$1,066,502	
Total	**$1,068,328**	

* These repairs were completed; however, undetected water leaks continued to damage the walls.
** This was reportedly completed; however, during the updated project capital needs assessment 2010 inspection, the entire parking garage structure was observed in poor condition.
Repairs listed in 2009 project capital needs assessment, repair items1 – 13.
New repairs not listed in 2009 project capital needs assessment, repair items 14 -27.