



Issue Date January 21, 2011

Audit Report Number 2011-LA-0001

TO: Tom Azumbrado, Director, San Francisco Multifamily Housing Hub, 9AHMLA
Joyce Allen, Director, Office of Multifamily Housing Development, HTD

Tanya E. Schulze

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: HUD Did Not Provide Adequate Oversight and Guidance During the Technical Review of the Retreat at Santa Rita Springs

HIGHLIGHTS

What We Audited and Why

We completed an internal audit of the Retreat at Santa Rita Springs (community), a Federal Housing Administration-insured multifamily property under the Section 231 of the National Housing Act.

The internal audit was performed as a spinoff of a prior external audit of the community. We conducted the audit in response to a congressional request from Representative Gabrielle Giffords of the 8th Congressional District of Arizona. In November 2009, the owners of the community defaulted on its \$29.9 million U.S. Department of Housing and Urban Development (HUD)-insured loan less than one month after final endorsement. Although the external audit disclosed that the community did not comply with applicable Federal rules and regulations and its regulatory agreement with HUD, those violations alone were not material enough to cause the owners to default on the loan. Therefore, the objective of the internal audit was to determine the cause(s) of the community's failure. We included HUD's technical review, Multifamily Accelerated Processing (MAP) lender's underwriting practices, and the owners' responsibilities in our internal audit to

determine the indications of noncompliance with Section 231 program requirements that may have contributed to the loan default.

What We Found

The community experienced huge operating shortfalls and eventually defaulted on the loan. The financial default was due to HUD's inadequate technical review and monitoring, the lender's failure to exercise due diligence in underwriting the loan, and the owners' lack of financial commitment and guidance to its management agent. As a result, the community's loan note was sold to an outside party for approximately \$9 million, or more than a \$20 million loss to HUD.

What We Recommend

We recommend that the Director of HUD's Office of Multifamily Housing Development update the MAP Guide to include rules and requirements for processing Section 231 loans and discontinue processing these types of loans until the MAP Guide is updated. We also recommend that the Director of HUD's Region IX San Francisco Office of Multifamily (1) ensure that all conditions for underwriting are met in processing Section 231 multifamily properties and that there are clear roles, responsibilities and communication among the HUD offices when conducting reviews to minimize potential problems such as those mentioned in this report and (2) improve the regional field office's property management and performance monitoring of Section 231 properties by beginning monitoring immediately upon occupancy to minimize potential financial, operational, and managerial problems related to the properties under the program.

These recommendations only address HUD's involvement during its technical review of the underwriting of this loan. The owners' and lender's involvement in the community were addressed outside this report.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided HUD a draft report on December 14, 2010, and held an exit conference on January 7, 2011. HUD provided written comments on January 13, 2011, and generally agreed with our report and recommendations.

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix A of this report.

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BACKGROUND AND OBJECTIVE

The Retreat at Santa Rita Springs (community) is a 196-unit multifamily independent living facility located in Green Valley, AZ. Its \$29.9 million Federal Housing Administration (FHA) loan was insured under Section 231 of the National Housing Act. The community's owners was the Retreat IL, LLLP, an Arizona limited liability limited partnership.

Paragon Mortgage, a U.S. Department of Housing and Urban Development (HUD)-approved Multifamily Accelerated Processing (MAP) lender, underwrote the loan. After initial endorsement in October 2007, the loan was assigned to Capstone Realty Advisors, LLC, and then assigned to Red Mortgage Capital, Inc., in June 2009.

Coppersands Incorporated (Coppersands) was the management agent approved at the firm application stage. In October 2008, the owners replaced Coppersands with another management agent, Watermark Retirement Corporation (Watermark). Watermark managed the community until it ceased operations in November 2009.

The community experienced huge operating shortfalls due to the owners' inability to lease up the property. The owners were able to maintain the property until October 2009 to ensure HUD's firm commitment approval for final endorsement of the community. Days after final endorsement, the owners stopped making loan payments and were unwilling to invest additional capital into the community. These actions led to the community's financial problems and the owners' loan default. On December 28, 2009, Red Mortgage assigned the loan to HUD. HUD recently sold the loan at a note sale for \$9.8 million, a loss of more than \$20 million. The sale of the loan to an outside party resulted in the community no longer being HUD insured.

HUD's Lender Qualification and Monitoring Division (LQMD) performed a quality assurance project default review of the community to evaluate the MAP lender's loan underwriting practice. On July 8, 2010, LQMD issued a report to the lender that covered the results of the review. HUD's Office of Inspector General (OIG) issued a separate external report reviewing the community's operations.

Our objective was to determine the cause(s) of the community's failure.

RESULTS OF AUDIT

Finding: HUD Did Not Provide Adequate Oversight and Guidance During the Technical Review of the Retreat at Santa Rita Springs

The community experienced operating financial shortfalls and eventually defaulted on the loan. Our review determined that HUD, the approved MAP lender, and the owners had contributed to the financial problems that hampered the community. HUD's inadequate technical review and property monitoring, the MAP lender's failure to exercise due diligence in its underwriting, and the owners' lack of financial commitment and guidance to its management agent contributed to the community's financial problems that led to the loan default. As a result, HUD incurred more than \$20 million in losses from the sale of the loan to an outside party.

HUD Provided Inadequate Oversight and Guidance

Underwriting Guidance Was Incomplete

On March 27, 2007, HUD issued Mortgagee Letter 2007-05, which authorized the use of the MAP Guide to process Section 231 loans. According to the mortgagee letter, chapters 3, 5, 6, 7 and 8 of the MAP Guide would be modified to reflect guidance on processing Section 231 loan applications. However, changes had not been made as of December 2010. Initially, the MAP Guide was used by the MAP lender in processing a Section 221(d)(4) loan application for the community in May 2007. When the program was changed to a Section 231 program upon HUD's recommendation, HUD and the MAP underwriter used the MAP Guide to process the Section 231 loan according to the mortgagee letter. Because no changes were made to the guide, there were no explicit instructions in the MAP Guide for processing Section 231 loans and HUD technical reviewers used the 221(d)(4) instructions in the MAP Guide without regard to the underwriting differences between the two programs. According to HUD, the significant underwriting differences between Section 221(d)(4) and Section 231 are the appraisal and market study because the studies for Section 231 would focus on the target market of potential residents who were 62 years of age and older and/or handicapped. Under Section 221(d)(4), the studies would not be age restrictive.

Underwriting Conditions Before Firm Commitment Approval Were Not Met

HUD approved the loan firm commitment for initial endorsement without verifying that the underwriting conditions it required had been met. However, HUD Handbook 4430.1 states that HUD's regional field office manager was responsible for ensuring that

underwriting conditions to the firm commitment were met before initial closing. The underwriting conditions for the community included the downsizing of the common area kitchen, revisions of the appraisal and market analysis, and submission of the required form HUD-92013-E for analysis of optional services that were to be provided to residents. This deficiency occurred because the HUD San Francisco and Phoenix multifamily offices did not understand their responsibilities for processing this loan.

As of August 2007, the HUD Region IX Office of Multifamily had issued a directive requiring that loan applications for more than \$15 million be reviewed by the San Francisco office for the preapplication and firm commitment stages of the loan process. Both the Phoenix and San Francisco offices performed technical reviews of the underwriting of the community's loan. Since the San Francisco office conducted a limited technical review of the underwriting, it did not use the required checklist for verifying whether underwriting requirements had been met. However, the Phoenix HUD office believed that both offices were conducting full technical reviews of the underwriting of the loan. As a result, neither HUD office understood its responsibilities in performing the technical review of the underwriting of this loan. HUD issued the firm commitment without the underwriting conditions having been met, and the community encountered the following issues:

The Kitchen Was Not Downsized

Section 231 allows projects to install modest or nonluxury equipment in a common area kitchen for use by the residents or outside and unrelated catering entities. However, HUD's review of the community's design found that the common area kitchen located in the 11,000-square-foot community/club house was more than a warming kitchen and recommended that it be downsized according to program requirements. The MAP lender responded and agreed that the specifications of the kitchen would be changed to conform to the requirements of Section 231. According to HUD, the kitchen was supposed to have only one stove, microwave, and refrigerator instead of two of each appliance. The purpose of the request was to reduce unnecessary construction costs and minimize potential financial issues at the community. However, the MAP lender did not conduct a follow-up inspection to verify whether the kitchen plans and specifications had been modified as requested by HUD. As a result, community house construction costs of at least \$1.5 million were not reduced.

The Appraisal and Market Study Were Not Updated

The owners' proposal stated that the community was an independent living facility with services such as optional meals, housekeeping, and transportation. It was originally underwritten under the Section 221(d)(4) program but was changed to Section 231 at HUD's recommendation. According to HUD's LQMD, both programs had similarities in the restrictions of mandatory meals and services. However, each program had different underwriting requirements. HUD program technical reviewers recommended an updated appraisal to revise the rent comparables and market study to meet Section 231 requirements. The HUD technical reviewers believed that the underwritten rents

provided in the exhibits for the Section 221(d)(4) loan application were higher than the intended market for residents seeking optional meals and services. However, HUD approved the firm commitment without an updated appraisal and market study under the Section 231 program.

Requirements Were Not Submitted

The MAP lender did not submit the required form HUD-92013-E, Supplemental Application and Processing Form - Housing for the Elderly/Disabled. This supplemental form should accompany the loan application for the processing of loans for multifamily properties that house elderly/disabled residents. HUD Mortgage Letter 2007-05 required the MAP lender to use this form and submit it with the Section 231 loan application due to the proposed optional services such as meals and transportation. The MAP lender acknowledged that this omission was an oversight on its part. However, HUD did not request this document to determine the validity of the proposal. As a result, the community incurred unapproved expenses related to optional services that HUD failed to review.

HUD Monitoring Was Inadequate

HUD was responsible for monitoring, as well as coordinating with owners, managing agents, lenders, subsidy contract administrators, and other clients, to ensure compliance with program rules and requirements. HUD was required to perform ongoing monitoring of the community during occupancy. In January 2009, the community began operations with initial occupancy occurring in February 2009. Throughout its entire operations, the community's occupancy rate did not exceed six percent. However, HUD did not perform property management and performance monitoring until September 2009, which was before the firm commitment on final endorsement in October 2009. During our review, we found that HUD did not provide adequate property management and performance monitoring of the community to ensure compliance with HUD requirements and regulations. The lack of adequate HUD monitoring resulted in various violations. The following violations contributed to the default of the community:

An Unapproved Management Was Operating the Community

Watermark was not HUD approved until September 2009. It replaced Coppersands in October 2008 and had been managing the community without HUD approval. Watermark's management of the community resulted in violations relating to the conversion of security deposits to community fees, the incurring of ineligible management costs, and duplicative billings being charged to the community. These issues occurred because the management agent had insufficient knowledge of HUD requirements for Section 231 program and disregarded the owners' regulatory agreement with HUD. During the external review of the community performed by the OIG, it was determined that these violations contributed to the community's financial instability.

The Community Was Not Marketed as Proposed in the Underwriting

HUD was not aware that the community was not marketed as proposed in the underwriting. The community was supposed to be an independent living facility that was viable without mandatory or optional services such as meals, housekeeping, and transportation. However, the community was marketed as a congregate care facility with the services listed above. The expectations of prospective residents for the community as a congregate care facility were not fulfilled because the promised amenities such as a bistro and beauty salon were not completed and operational during occupancy. There were many prospective residents who applied for residency at the community but decided not to move in due to the lack of the promised amenities. During its operation, the community had a total of 13 residents. As a result, the community's lack of these marketed amenities factored into the owners' inability to attract potential residents and lease up the property.

Community Rents Marketed More Than Underwritten Rents

The management agent charged rents at approximately 50 percent more than the underwritten rents. HUD could have acted and declared the community in technical default because of this lapse in following HUD rules and regulations. However, HUD did not know that the increased rents were more than the proposed underwritten rents until other problems with the community were discovered. Had HUD conducted adequate and timely monitoring of the community, it could have prevented the management agent from increasing the rents. These advertised rents at the community, which were higher than the underwritten rents, hindered the owners' ability to lease up the community and factored into its low occupancy.

Required Monthly Reports Were Not Submitted to HUD

The community owners were required to submit monthly reports to HUD. These monthly reports provided information such as lease ups, rent revenue, operating expenses, cash availability, security deposits, and other information needed to evaluate the property's operation. The community started operations in January 2009, and tenant occupancy began in February 2009. However, HUD did not receive the first required monthly report until May 2009. There was no apparent follow-up on the part of HUD to request outstanding monthly reports from the owners. HUD's failure to request required monthly reports from the owners left it unaware of the community's escalating financial problems.

The Owners Violated Section 231 Program Requirements

Section 231 properties have restrictions on mandatory or optional meals and services. The owners were allowed to have a warming kitchen in the community's congregate area for catered food provided by an outside entity unrelated to the owners. The owners violated these requirements due to HUD's lack of monitoring at the community. The owners also hired a chef that prepared meals for the residents. To meet Pima County

Health Department requirements for a food establishment, the community's executive director started to convert the kitchen into a commercial grade kitchen by purchasing a commercial grade refrigerator and two commercial grade microwaves. In addition, the executive director had applied for a food establishment license to operate the commercial kitchen. The establishment of a commercial grade kitchen at the community was in direct violation of Section 231 program rules. However, HUD's lack of adequate monitoring at the community allowed these violations to occur during the process.

Escrowed Funds Were Depleted Faster Than Projected

The lender required the owners to provide at least \$597,600 toward a working capital fund and \$768,763 toward an initial operating deficit fund. These funds were supposed to last at least 12 months from the community's initial occupancy to cover potential financial shortfalls. The lender controlled all disbursements of these funds, while HUD approved the disbursement requests. However, the owners exhausted both funds months after the initial occupancy. One of the reasons for the immediate expenditure of funds was the increased expenses incurred for unapproved meals and services. An outside entity was supposed to provide these optional meals and services without the community incurring any of the related expenses. HUD's inadequate monitoring allowed the community to incur food expenses such as groceries and payroll expenses that should not have been allowed.

Final Endorsement Was Approved Without a Financial Commitment From the Owners

The owners began to default on the community's first loan payment in July 2009. The owners also did not make a loan payment in August and September. However, HUD did not become aware of the owners' loan default until September 2009. When the problem became evident, HUD intervened and met with the owners to determine whether the community would be able to proceed to final endorsement in October 2009. The owners stated that they would be able to fund the loan payments to make the loan current through September 2009. The owners stated that the October 2009 payment would be deducted from the loan proceeds from the final closing. The owners had planned to seek additional partners for more available capital to assist the community financially or sell the community to an interested investor, which would have required HUD's consent to a transfer of assets. If the community were sold to an investor, the transfer of assets would have required the owners to provide additional funds to the property until it broke even financially. However, HUD did not wait for this plan to materialize and immediately proceeded with final endorsement without a financial commitment from the owners.

The regional director stated that HUD's Phoenix office should have monitored the property more closely and identified the potential red flags during the final endorsement process. The director went on to state that HUD could have delayed the final endorsement process if it had known of the community's situation. Unfortunately, HUD, the owners, and the MAP lender focused on closing the loan to minimize risk. As soon as the owners achieved the minimum requirement for closing, which is having the loan

payments current, HUD proceeded immediately for firm commitment on final endorsement.

HUD eventually knew of these violations but did not act to correct them. According to HUD, these should have been considered technical violations. However, HUD's, the MAP lender's, and the owners' goal during that time was to proceed to final endorsement.

The MAP Lender Failed To Exercise Due Diligence in Underwriting This Loan

In July 2010, HUD LQMD issued a report related to its December 2009 onsite default project review of the community. Its objective was to determine whether the HUD-approved MAP lender performed its underwriting of the loan in accordance with applicable HUD rules and requirements. Based on the review, LQMD identified various causes, findings, and observations in the underwriting of the loan that led to the owners' loan default and noncompliance with applicable HUD rules and requirements. Among the causes, LQMD's findings and observations regarding the MAP lender's underwriting of the community included

The Owners Were Inexperienced

The owners acknowledged that they had no substantial experience in elderly multifamily housing under the Section 231 program. An experienced owner is critical in ensuring that a property with elderly residents is financially sustainable to operate with minimal problems. For example, the owners should have known that advertising the community as a congregate care facility and asking for rents at 50 percent more than the underwritten rents would factor into their ability to lease up the property. According to the management agent, the community was neither an independent living facility nor an assisted living facility. Without a clear understanding of the type of elderly housing that was intended for the community, the owners hindered their ability to attract prospective residents to occupy the community. The MAP lender stated that they agreed with HUD's LQMD comment that they failed to provide an experienced owner in elderly housing particularly during the economic period in which the project came on line. In response to LQMD's comment, the lender stated it would implement corrective actions in future loans to ensure owners have adequate experience in managing properties such as the community.

Financial Capacity Was Not Established

The owners formed a limited liability limited partnership to operate the community. They contributed land that was appraised at \$2.5 million as equity toward the loan. Since the land was used as collateral toward the loan, the MAP lender did not require the

owners to provide cash toward the loan. Although the MAP lender appeared to have provided assurance that the community was fully capitalized by requiring working capital and initial operating deficit escrows, it should have performed a more extensive analysis of the financial capacity of the owners beyond the minimum requirements. Elderly properties such as the community are long-term investments that need continued financial support from owners to ensure financial stability. Therefore, the capital needed for properties such as the community should be beyond the established requirements needed to operate the community and minimize potential problems.

The Appraisal and Market Study Were Not Updated

In March 2007, a contracted third-party firm performed an appraisal and market study as part of the application for the community under the Section 221(d)(4) program. After the application package with the appraisal and market study were completed, the owners decided to apply for Section 231 loan financing instead of the Section 221(d)(4) loan financing using their original application package. In August 2007, the MAP lender believed that this appraisal and market study used for the Section 221(d)(4) loan application was applicable for use under the Section 231 loan program. It stated that the market study analyzed the same target, competition, and demand under the Section 231 as under the Section 221(d)(4). However, our review of the market study showed that the demand for independent living housing consisted of individuals 75 years of age and older. However, the study stated that this target group mostly had disabilities and needed meals and other supportive services. The study further stated that there was no market for an independent facility with optional meals and other supportive services for residents 75 years of age and younger.

The study also found that the Green Valley area had a population, of which only six percent of residents were under the age of 75. These residents were considered to be healthy, mobile, and active individuals who may have wanted but did not need optional meals and services. This was the target group intended to reside at the community. Further, the market study provided as an exhibit with the Section 221(d)(4) application submission stated that in 2006, Tucson home sales and prices fell and that the data indicated a continued slowdown in the housing market with an indirect impact on the community. Based on the data and analysis, the community would have enjoyed a strong prelease and initial rent up as a result of potential residents' selling their homes at a profit. The market study projected a 93 percent occupancy rate at the community. The study also estimated that the annual demands for units at the community in 2007, 2008, and 2009 were to be 107, 111, and 114, respectively. However, our review found that the community had only 13 units occupied during its entire operation.

The appraisal for the community included incorrect information related to the occupancy rates among comparable properties. Specifically, the appraiser reported that one of the comparable properties had an occupancy rate of 95 percent. However, discussions with a HUD appraiser found that the comparable property had an occupancy rate of 77 percent since June 2007. HUD had considered this is a serious discrepancy. Since the MAP lender did not request a revised appraisal report, HUD technical reviewers believed that the underwritten rents were higher than the market rents in the area.

There Was an Economic Downturn in the Area

When the loan application was submitted in May 2007, there appeared to be indications of a decline in the economy. However, the MAP lender's appraisal and market study projections showed a high demand for occupancy of independent living facilities with meals and other supportive services. According to the MAP lender, it had underwritten the loan conservatively but did not update the appraisal and market study to reflect the present economic conditions. As a result, the MAP lender used outdated market data to underwrite the loan.

According to the LQMD report, the underwriter's failure to exercise prudent underwriting practices during the collapsing economy contributed to the owners' defaulting on the loan and the community's financial instability. The lender could no longer do anything about this loan but said that they would implement tighter underwriting procedures for the new loans they would make. LQMD stated that it would close all report comments except for the issue of identity of interest, which was being recommended for further review.

The Owners Failed To Provide the Necessary Financial Commitment and Guidance to Their Management Agent

The owners' financial commitment to the property ended when they exhausted their capital contributions. A property such as the community needed the owners' continued financial support to ensure its financial stability. Although the owners' other partners had also signed statements of financial commitment to provide additional funds as necessary until the community was financially sustainable, HUD could not enforce the commitments. This condition existed because the loan was a nonrecourse loan and the partners' involvement in the community was only as limited liability partners. Although these partners had liquid assets of more than \$48.3 million, they were unwilling to commit additional funds to the property. Although it was not required by HUD or the lender, committed owners should know that the capital needed to operate properties such as the community should be beyond the required amount needed to minimize financial uncertainties.

Our prior external audit of the management agent's practice found instances in which they did not operate the community in accordance with Federal rules and regulation and its regulatory agreement with HUD related to the Section 231 program. According to the review, the owners' lack of knowledge related to HUD-insured elderly properties, such as those financed under the Section 231 program, played a role in the property's financial problems. This lack was evident among the problems found that included conversion of security deposits to community fees, ineligible management cost, and unsupported duplicative billings charged to the property. These practices resulted in fewer funds being available to pay for eligible expenses. An owner experienced in elderly properties

such as the community would have the capability to address critical issues that could affect daily operations. An experienced owner would not have allowed the management agent to advertise the community's unit rents at more than the underwritten rents, which hampered efforts to lease up units.

Conclusion

HUD's inadequate oversight and guidance, the MAP lender's failed due diligence in underwriting, and the owners' lack of financial commitment and management expertise caused the community's financial problems that led to the owners' loan default. These problems also led to HUD's selling the loan to an outside party for approximately \$9 million, or more than \$20 million less than the original \$29.9 million loan initially insured by HUD.

Recommendations

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

- 1A. Update the MAP Guide with rules and requirements for processing Section 231 program loans and discontinue processing these types of loans until the MAP Guide is updated.

We recommend that the Director of HUD's Region IX San Francisco Office of Multifamily

- 1B. Ensure that all conditions for underwriting are met in processing Section 231 multifamily properties and that there are clear roles, responsibilities and communication among the HUD offices when conducting reviews to minimize potential problems such as those mentioned in this report.
- 1C. Improve the regional field office's property management and performance monitoring of Section 231 properties by beginning monitoring immediately upon occupancy to minimize potential financial, operational, and managerial problems related to the properties under the program.

SCOPE AND METHODOLOGY

We performed onsite work at the HUD field offices in San Francisco, CA, and Phoenix, AZ, from September to November 2010. The internal review covered the period May 2007 through November 2009, which included submission of the loan application to the loan default.

To accomplish our objective, we

- Reviewed applicable laws, regulations, and guidance issued by HUD (see criteria in appendix B).
- Reviewed pertinent documents maintained by multifamily staff at the HUD Phoenix program center and San Francisco hub.
- Interviewed HUD technical reviewers and supervisors from the HUD Phoenix program center and San Francisco hub.
- Interviewed the HUD-approved MAP lender and underwriter.
- Reviewed the loan application and narrative summary including exhibits submitted by the MAP lender.
- Reviewed LQMD reports.
- Interviewed the LQMD director and staff.
- Reviewed OIG's external report performed on the community's operations.
- Reviewed HUD's technical review reports on the HUD-approved MAP lender's underwriting practice and HUD's oversight and monitoring.

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. 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:

- Monitoring the property's operations in compliance with applicable laws and regulations and
- Maintaining complete and accurate records.

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.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- HUD did not have adequate controls in place for oversight and guidance during its monitoring and technical review of the community (see finding).


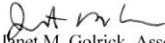
APPENDIXES

Appendix A

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

 OFFICE OF HOUSING	U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT WASHINGTON, DC 20410-8000	JAN 13 2011
MEMORANDUM FOR:	Elizabeth Y. Sarmiento, Senior Auditor, Office of Inspector General for Audit, 9AGA	
FROM:	 Janet M. Golrick, Associate Deputy Assistant Secretary for Multifamily Housing Programs, HT	
SUBJECT:	Response to 2011-LA-100X; Review of the Retreat at Santa Rita Springs, FHA #123-38033	
<p>This memorandum is in response to Office of Inspector General (OIG) Report 2011-LA-100X, prepared on the Retreat at Santa Rita Springs at the request of Representative Gabrielle Giffords. The OIG found that the community experienced huge operating shortfalls and eventually defaulted on the loan. It is the OIG's opinion that the financial default was due to HUD's inadequate technical review and monitoring, the lender's failure to exercise due diligence in underwriting and the owner's lack of financial commitment and guidance to its management agent. Following is Multifamily Housing's response to OIG's findings.</p>		
<p><u>OIG Findings: HUD Provided Inadequate Oversight and Guidance:</u> The OIG report states that HUD provided inadequate oversight and guidance in terms of underwriting rules and requirements. HUD issued Mortgagee Letter 2007-5, which authorized the use of the MAP program to process Section 231 loans, with the stipulation that the MAP guide would be updated in the future to incorporate guidance on processing Section 231 applications. In the case of Santa Rita Springs, because there were no explicit instructions in the MAP guide for processing Section 231, HUD technical reviewers and the lender used 221(d)(4) processing instructions in the MAP Guide without regard to the program variances between Section 221(d)(4) versus Section 231. The application and processing errors associated with the lack of MAP processing guidance specific to Section 231 is believed to have been one of the contributory factors in the property's eventual failure.</p>		
<p><u>HUD Response:</u> Although MAP Guide did not have instructions on processing Section 231 applications, the Hub used the underwriting guidance and parameters contained in Mortgagee Letter 2007-05 and its clarifying memorandum on meals policy issued on July 16, 2008. The MAP Guide has been updated to fully incorporate the Section 231 processing instructions and is currently being prepared for Departmental clearance and we expect publication the second quarter of 2011.</p>		
<p><u>OIG Findings: Underwriting Conditions Before Firm Commitment Approval were not met:</u> OIG has found that HUD approved the Firm Commitment for Initial Endorsement without verifying that processing requirements and underwriting conditions had been met. Specifically;</p>		
<ul style="list-style-type: none">• The kitchen was not downsized.• The appraisal and Market Study were not updated.		
<p>www.hud.gov espanol.hud.gov</p>		

- Form HUD 92013-E, “Supplemental Application and Processing Form for Housing for the Elderly/ Disabled” was not submitted.

HUD Response: HUD concurs that adequate oversight was not exercised in determining the conditions stipulated in the firm commitment were not met. Specifically, the kitchen was not downsized and Form 92013-E was not submitted. In response, the attached “Hub Risk Assessment and Loss Mitigation Plan” addresses enhancements to project monitoring during construction phase that will be implemented by the San Francisco Hub, to include better coordination with Asset Management during the construction, lease-up and stabilization periods.

HUD does not agree that the appraisal and market study were not updated. The appraisal and market study were updated by HUD staff, which is permitted under MAP at the discretion of the Processing Office.

OIG Findings: HUD Monitoring Was Inadequate: OIG has found that HUD was responsible for monitoring to ensure compliance with program rules and requirements. Initial occupancy of the property began in February 2009. OIG has found that HUD did not perform property management and performance monitoring until September 2009. The lack of HUD oversight during this period resulted in the following violations:

- An unapproved and unqualified management agent replacing the approved management agent.
- Community not marketed as proposed in underwriting.
- Rents marketed greatly in excess of underwritten rents.
- Monthly reports to HUD were not submitted.
- Violation of Meal Service restrictions.
- Improper dispersal of escrows.
- Final endorsement approved improperly.

HUD Response: HUD concurs that there was inadequate oversight during the period between initial and final endorsement. The attached Risk Assessment and Loss Mitigation Plan has been drafted by the San Francisco Hub to specifically address project monitoring during construction and better coordination with Asset Management during the lease-up and stabilization period. This is currently in the process of being implemented by the Hub.

OIG Findings: The MAP Lender Failed to Exercise Due Diligence in Underwriting the Loan: OIG found that the lender failed to insure that the project’s ownership was experienced and their financial capacity was not established. Additionally, the appraisal and market studies were not updated.

HUD Response: HUD concurs with the OIG that the MAP Lender failed in their due diligence assessment. In response, HUD plans on issuing a warning letter to the lender itemizing the noted deficiencies. The warning letter will mandate enhanced monitoring of the lender for a period of one year, which may be extended at the discretion of the Director of Multifamily Housing Development if warranted. HUD also intends to refer a potential Identity of Interest violation to the Office of General Counsel to determine if litigation or further enforcement actions may be appropriate.

Comment 1

OIG Findings: The Owners failed to provide the necessary financial commitment and guidance to their management agent:

HUD Response: HUD concurs with the OIG that the project failure can be partially attributable to the fact that the ownership was no longer committed to the project's success once their capital contributions were exhausted.

OIG Recommendations

IG Recommendation 1A: Update the MAP Guide with rules and requirements for processing Section 231 program loans and discontinue processing these types of loans until the MAP Guide is updated.

HUD Response: FHA has a pipeline of approximately 22 Section 231 applications, many of which are already subject to firm commitments and/or initial endorsements. Discontinuing processing of these applications would not be practical due to the contractual commitments by the Department associated with these applications. Multifamily Housing believes that it can continue to process Section 231 loans while the MAP Guide is in clearance under the following conditions:

- The MAP Guide has now been revised to incorporate instructions for processing Section 231. The Guide will soon be placed into Departmental Clearance and is anticipated to be published during the second quarter of FY 2011.
- Concurrent with the MAP Guide clearance, Multifamily Housing will issue more comprehensive policy guidance for seniors and age restricted housing, including oversight of rent up after construction completion and the property stabilization period. This guidance will apply to all of our programs.
- Until the MAP Guide is published, Multifamily Housing will require that all Section 231 applications require National Loan Committee approval.

IG Recommendation 1B: Ensure that all conditions for underwriting are met in processing Section 231 multifamily properties and that there are clear roles, responsibilities and communication among the HUD offices when conducting reviews to minimize potential problems such as those mentioned in the report.

HUD Response: HUD concurs that there were deficiencies in processing by the HUD office. Please see attached response for itemized measures to be implemented to insure that these deficiencies are addressed.

IG Recommendation 1C: Improve the regional field office's property management and performance monitoring of Section 231 properties by beginning monitoring immediately upon occupancy to minimize potential financial, operational, and managerial problems related to the properties under the program.

HUD Response: HUD concurs that there was inadequate monitoring during the period between initial endorsement and project stabilization. Please see attached response for itemized measures to be implemented to insure that projects are constructed and marketed as proposed.

If you have any questions, please contact Terry Clark, Director of Lender Qualifications and Monitoring Division, Office of Multifamily Programs at 202-402-2663.

Attachment

cc: Thomas Azumbrado, Director, San Francisco Multifamily Hub

OIG Evaluation of Auditee Comments

Comment 1 The report stated that HUD's technical reviewers recommended that the appraisal and market study should have been updated by the approved MAP lender since it was created to support the Retreat at Santa Rita Springs' application under Section 221(d)(4). When the application was changed to a Section 231 property, the underwriting differences between Section 221(d)(4) and Section 231 programs were not taken into consideration. We agree that HUD performed an appraisal and market study of the property under the Section 231 program. However, HUD based its conclusions on the MAP lender's original appraisal and market study that was submitted under the Section 221(d)(4).

Appendix B

CRITERIA

HUD Handbook 4350.1, REV-1, Section 1-1. Goals, Responsibilities, and Relationships

- 1-3. Monitoring. In carrying out this mission, HUD monitors and works with mortgagors, managing agents, mortgagees, subsidy contract administrators, and other clients to assure compliance with the requirements of HUD's programs.
- 1-13. HUD Asset Management Functions. To a varying degree, HUD Field Office Loan Management (Asset Management) Branch staff are involved in the following asset management functions:
- A. Development of Projects: Management input into the approval or disapproval of ownership structure and management and the proposed practices during the development stage of the project.
 - B. Transfers of Physical Assets (TPAs): Review proposed changes in ownership when under management.
 - C. Property Management:
 - 1. Review proposed added capital improvements or refinancing proposals, including projections of performance, when under management.
 - 2. Conduct property management reviews and assist owners and managing agents to achieve effective property management.
 - 3. Conduct physical inspections of projects.
 - 4. For most projects, establish rental rates.
 - 5. Analyze insurance coverage for adequacy.
 - 6. Where applicable, assure that the model form of lease is used.
 - 7. Monitor rental market conditions.
 - 8. Monitor Management Improvement and Operating (MIO) plans.
 - 9. Approve additional forms of subsidy, such as Flexible Subsidy Operating Assistance, Capital Improvement Loans, and Loan Management Set Aside Section 8 assistance.
 - D. Performance Monitoring of All Projects:
 - 1. Analyze annual and monthly financial statements.
 - 2. Analyze the project's overall performance and potential.
 - 3. Analyze subsidy requirements, types, usages, reserves, and availability.
 - 4. Analyze long term capital needs.
 - 5. Assure the owners analyze property tax assessments.
 - 6. Consider mortgage relief when appropriate.
 - 7. Ensure owners provide adequate housing at the lowest possible cost.

- E. Additional Performance Monitoring of Projects With HUD-Held Mortgages, including direct loans:
 - 1. Assist in escrow analyses.
 - 2. Analyze causes of default and/or delinquency.
 - 3. Combine the results of analyses and work with owners/managing agents in developing reinstatement plans, including modification or restructuring of indebtedness.
 - 4. Collect all debt, particularly delinquent debt.
 - 5. Initiate foreclosure when necessary.

HUD Handbook 4430.1, REV-1, Section 1-3. Authority and Responsibility for Closing

- A. Field Office Manager (Regional Director of Housing performs all Field Office Manager initial closing functions for Regional Offices) is responsible for:

- 1. Assuring that conditions of the commitment are met.

HUD Handbook 4470.1, REV-2, Mortgage Credit Analysis for Project Mortgage Insurance, Chapter 3. Financial Statements

- 3-5. OBJECTIVE OF FINANCIAL STATEMENT ANALYSIS. Financial statements provide historical information for measuring and evaluating financial performance and provide advance warning of financial problems.

3-6. HOW TO ANALYZE FINANCIAL STATEMENTS

- F. If funds are being provided by a parent company or affiliate of the sponsor:

- 1. Require a certification from the Board of Directors or authorized agent that specifies the funds the parent company/affiliate is willing to commit.

HUD Handbook 4570.1, REV, CHG-2, Section 1-1. Nature and Purpose of Section 231

- b. There is no substitute for a strong and capable sponsorship primarily concerned with the continuing operation of a project for the elderly and/or handicapped rather than just its initiation. Sponsors of profit-motivated projects should be interested in long-term investment, with profits from construction as a secondary consideration. Both profit-motivated and non-profit sponsorships must be financially capable and willing to provide funds as may be necessary in the completion and operation of a project.

HUD Handbook 4570.1, REV, CHG-2, Chapter 2, Section 4

- d. Congregate Living: Congregate living facilities may be considered by any eligible mortgagor. He may propose to supply tenants with food, furniture, maid service, health insurance, infirmary, limited nursing care, or other personal services. Regardless of the nature and extent of the congregate facilities provided, each dwelling unit shall contain at

- a minimum; a kitchen sink, a minimum size standard refrigerator, a “cook top,” adequate electrical capacity and outlets for small appliances, storage space for food and utensil storage and complete bathroom facilities. Where a mortgagor proposes to furnish food or other services, the sponsor shall clearly separate such charges from the total charges for shelter, rent and utilities which are entered on FHA Form 2013. Also, the sponsor's FHA Form 2013 should contain only those expenses estimated to be required to supply living quarters including utilities. FHA Form 2013-E will be used to show estimated expenses and income relating to meals and other services.

HUD Handbook 4570.1, REV, CHG 2, Chapter 2, Section 4

- g. Firm Commitment Stage: At this stage, final plans and specifications are reviewed. With a Design Representative assigned to the project, there should be conformity with previous concepts and decisions agreed upon by HUD-FHA and the sponsor, and there should be no changes in plans which are not approved by HUD-FHA as design progresses. Again, reanalysis is limited to changes necessitated by sponsor actions. Otherwise, all HUD-FHA decisions previously made must stand.

Mortgagee Letter 2007-05

The following are basic policies which apply to all loans (MAP or Traditional Application Processing (TAP)):

- (1) Mortgagee Letter restates outstanding Departmental policy regarding Section 231 and authorizes the use of the MAP to process Section 231 mortgages. Section 231 project mortgages shall comprise eight or more new or rehabilitated units designed for use and occupancy by elderly persons.
- (2) For new construction cases, Section 231 is a replacement cost program like Sections 221(d)(3) and 221(d)(4).
- (3) Section 231 mortgages have the same restrictions on mandatory meals and services, central kitchens and dining areas, and non-shelter spaces as Section 221(d)(3) and 221(d)(4) mortgages. Non-shelter services may not be made a mandatory condition of occupancy. Charges for any optional services must be reviewed by the MAP Lender and approved by HUD for reasonableness. Institutional central kitchens are not permitted, nor may the project provide meal services on either a mandatory or optional basis. The prohibition does not preclude the installation of modest (non-luxury) equipment in a common use kitchen (for example, sink, stove, or refrigerator) in a non-shelter space for use of tenants or by outside entities providing catered meals.
- (4) Where optional services are proposed, i.e., a Form HUD 92013-E must be submitted with the insurance application. The HUB/Program Center must make a determination that any service program is self-supporting. No optional service income can be used in the net income calculation to support mortgage debt service.

- (5) The provisions of this letter cannot be waived by HUD directors. Chapters 3, 5, 6, 7 and 8 of the current MAP Guide will be modified to reflect this guidance on processing Section 231 applications.

MAP Guide, Section 8.4, Firm Commitment Processing Financial Statements, C. Processing for Financial Statements

9. Sponsor's Continuing Commitments

- a. A written statement must be submitted from principals who are sponsors indicating the parameters of their financial commitment to and contractual relationship(s) with the mortgagor:
 - (1) If the relationship is not intended to continue until the project reaches sustaining occupancy, the financial requirements have not been met.
 - (2) Any sponsor not having an ownership interest in the mortgagor entity must also certify in writing the amount it is willing to commit.

MAP Guide, Section 8.4, Firm Commitment Processing Financial Statements, C. Processing for Financial Statements

10. Individuals are prohibited from submitting financial statements as a sponsor and then abandoning the project and the mortgagor after the Firm Commitment is issued.

MAP Guide, Chapter 12, Insurance Closings, Section 12.1.2, Authority and Responsibility for Closing

A. The Hub Director is responsible for:

1. Assuring that conditions of the HUD Firm Commitment are met.