Issue Date June 26, 2009	
Audit Report Number 2009-FW-1010	

TO: Brenda L. Waters
Acting Director, Kansas City Multifamily Hub, 7AHM

Henry S. Czauski, Acting Director, Departmental Enforcement Center, CV

Gerald R. Kirkland

FROM: Gerald R. Kirkland
Regional Inspector General for Audit, Fort Worth Region, 6AGA

SUBJECT: Harry Mortgage Company, Oklahoma City, Oklahoma, Overstated the Financial Wherewithal of the Owner and General Contractor and Overestimated the Qualifications of the General Contractor When Underwriting the Cypress Ridge Apartments' $5.87 Million Loan under the Multifamily Accelerated Processing Program

HIGHLIGHTS

What We Audited and Why

In response to requests from the U. S. Department of Housing and Urban Development (HUD) and Senator James Inhofe, we audited the property owner's application and the loan processing and underwriting of the HUD-insured mortgage loan to Greystone Apartments, Inc., for Cypress Ridge Apartments. Harry Mortgage Company, the lender, processed and recommended loan approval under the multifamily accelerated processing (MAP) program.

The audit objective was to determine whether the lender satisfied HUD requirements for processing and underwriting the $5.87 million mortgage loan to rehabilitate Cypress Ridge Apartments.

What We Found

The MAP lender's underwriting analysis did not assess, as required, the financial wherewithal of the owner and general contractor, which are related entities, or the construction capabilities of the general contractor. As a result, the MAP lender did not identify risk and take necessary corrective action before recommending the loan for approval. Based on the lender's recommendation, HUD approved the project and general contractor. The project failed, resulting in a $3.7 million loss on the mortgage loan insured by the Federal Housing Administration (FHA).

What We Recommend

We recommend that the Acting Director of HUD's Kansas City multifamily hub request that the Mortgagee Review Board take action against Harry Mortgage Company for negligence that resulted in a default and a resulting FHA insurance claim on Cypress Ridge Apartments. Further, we recommend that the Acting Director of HUD's Enforcement Center take action against Harry Mortgage Company for negligence that resulted in a default and a resulting FHA insurance claim on Cypress Ridge Apartments.

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

On June 4, 2009, we provided a discussion draft report to the MAP lender. On June 11, 2009, we held an exit conference with HUD and the lender. On June 22, 2009, we received the lender's written comments on the draft. The lender did not agree with the finding.

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

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BACKGROUND AND OBJECTIVE

Section 221(d)(4) of the National Housing Act authorizes loans insured by the Federal Housing Administration (FHA) for the substantial rehabilitation of rental housing. Under multifamily accelerated processing (MAP) program guidelines, the sponsor works with a MAP-approved lender, which submits required exhibits for the preapplication stage. After the U. S. Department of Housing and Urban Development (HUD) reviews the exhibits, it either invites the lender to apply for a firm commitment for mortgage insurance or declines to consider the application further. For acceptable exhibits, the lender submits the firm commitment application, including a full underwriting package, to HUD for review to determine whether the loan is an acceptable risk. Considerations include market need, zoning, architectural merits, capabilities of the borrower, etc. If HUD determines that the project meets program requirements, it issues a commitment to the lender for mortgage insurance.

In May 2005, the Multifamily Program Center in Oklahoma City, Oklahoma (center), received a Section 221(d)(4) mortgage loan application from Harry Mortgage Company, a MAP-approved lender, for Greystone Apartments, Inc., the owner of Cypress Ridge Apartments. The center issued an initial endorsement for a $5.87 million mortgage loan on December 14, 2005. For comparable jobs, HUD reported that contractors usually complete substantial rehabilitation within 12 months. In the appraisal, the contractor estimated that it would take nine months to complete the rehabilitation.

One company managed the property and carried out the rehabilitation project. Williams Commercial Property Management, Inc. (management company), was the management agent that managed Cypress Ridge Apartments. Harry Mortgage Company recommended and HUD approved the management company as the general contractor to carry out the property rehabilitation. William L. Sharpe, a shareholder of Greystone Apartments, Inc., and the principal contact person for ownership, owned the management company.

On October 1, 2007, 22 months after obtaining the loan, the owner defaulted on the loan. At the time, the general contractor had finished only about 57 percent of the rehabilitation, which it did not complete. The lender assigned the note to HUD, and HUD recorded the assignment on November 28, 2007. It paid more than $4.2 million to Harry Mortgage Company for the Greystone Apartments, Inc. (Cypress Ridge Apartments), insurance claim settlement and sold the mortgage note for $484,376, a loss of more than $3.7 million.

HUD’s Lender Qualifications and Monitoring Division (division) in headquarters conducted a project default review of Cypress Ridge Apartments during the week of October 29, 2007. Its purpose was to determine what caused the default and whether the MAP lender and HUD had complied with program requirements. The division’s June 24, 2008, report concluded that the MAP lender primarily caused the default by not performing an adequate underwriting analysis. The report stated that the lender overstated the economic feasibility and minimized the risk of the loan, resulting in an under scoped rehabilitation plan, an incomplete rehabilitation, and poor construction.[1] The division's determination was that the misrepresentation by the lender's underwriter was the primary reason for the construction loan default and assignment of the loan. Requests to perform this audit came from Senator James Inhofe and the HUD Kansas City multifamily hub office. The center did not receive a copy of the division's report until December 2008, when we were well into our audit. While the center did not take action against Harry Mortgage Company because it elected to get out of the FHA multifamily business, the center did flag the owner, its principals, and Williams Commercial Property Management, Inc. in HUD's Active Partners Performance System for their poor performance in carrying out the Cypress Ridge Apartments' project.

The audit objective was to determine whether the lender satisfied HUD requirements for processing and underwriting the $5.87 million mortgage loan to rehabilitate Cypress Ridge Apartments.

This is the first of two reports on the project. The second report will address funding used to rehabilitate and operate the property.

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1 Our audit did not conclude that the general contractor carried out the project with a severely under scoped rehabilitation plan as the division concluded. We did not find a material number of unplanned work items excluded from the work scope or that the independent architect or engineer agreed with the division's conclusion.

RESULTS OF AUDIT

Finding: The Lender Overstated the Financial Wherewithal of the Owner and General Contractor and Overestimated the Qualifications of the General Contractor

The lender did not thoroughly analyze the financial conditions of the owner and general contractor as required by the MAP Guide. The lender also did not accurately assess the qualifications of the general contractor. The lender's underwriter did not practice the required due diligence during its analyses. As a result, the lender reported to HUD unsupported wherewithal for the owner and general contractor and construction capability that was not evident. Relying on the lender's recommendation, HUD insured the mortgage loan for a project that the owner and its related general contractor could not complete, resulting in a loss to HUD of more than $3.7 million.

The Lender Did Not Obtain Sufficient Financial Information to Analyze the Financial Conditions of the Owner or the General Contractor

The lender did not obtain sufficient financial information to determine whether the owner and general contractor had sufficient working capital to undertake the project. Working capital is the excess of current assets over current liabilities. The MAP Guide required the lender's underwriter to make a working capital determination for the owner and the general contractor using their financial statements. The determinations affect the lender's recommendation as to whether HUD should approve the loan. The lender's underwriter should have reviewed the owner's working capital to ensure that the owner had sufficient cash to maintain operations through the construction period. If the general contractor's working capital was insufficient, the lender should have required it to establish a joint venture with a financially stronger general contractor or replaced the general contractor before recommending the loan to HUD for approval.

For the owner, Greystone Apartments, Inc., the underwriter did not obtain a balance sheet or have other means to calculate working capital. Nevertheless, in the narrative accompanying the recommendation to approve the loan, the lender falsely reported to HUD that it had performed a careful review of the owner's financial condition and had no negative findings to report.

For the general contractor, Williams Commercial Property Management, Inc., the underwriter calculated working capital based on (1) selected current asset and liability balances from an unaudited balance sheet that did not identify current liabilities and (2) cash confirmed by banks. The method was not consistent with the MAP Guide, which requires the underwriter to use financial statements, not bank confirmations.

The MAP Guide required[2] the general contractor to have working capital that was 5 percent of the amount of the rehabilitation contract. Using the cash confirmed by the banks, the lender wrongly concluded that the general contractor had $147,549 in available working capital and reported to HUD that the general contractor had working capital that was 7.1 percent of the contract amount. If the lender had used the cash reported in the balance sheet in its calculation, as required by the MAP Guide,[3] it would have concluded that the general contractor had a negative $19,541 in working capital.

The lender reported to HUD that, after careful review, the underwriter found no negative finding to report regarding the general contractor's financial condition. This would not have been the case if the underwriter had required the general contractor to provide a breakdown of current and long-term liabilities, used the cash balance from the balance sheet, and identified the current portion of long-term debt, as the MAP Guide required.[4]

In addition, the MAP Guide required the lender to obtain an income statement and several supporting schedules. The general contractor only submitted the balance sheet for the most recent three years. Without these additional documents, the lender could not perform a complete financial analysis.

The Lender Did Not Make a Valid Determination of the General Contractor's Construction Capability

The lender's evaluation of the general contractor's construction capability did not affirm the general contractor's experience in terms of type and size of previous projects. This condition occurred because the lender's underwriter did not exercise required due diligence when it analyzed the general contractor's résumé of experience.

According to requirements,[5] "the underwriter serves as a member of the Lender's processing team, calling for specific requirements and terms in the preparation of

[2] MAP Guide, chapter 8, section 8.4.C.12.d
[3] MAP Guide, chapter 8, section 8.4.C.3
[4] MAP Guide, chapter 8, section 8.4.B.2.a
[5] MAP Guide, chapter 8, section 8.1.B.1

underwriting recommendations to HUD." The underwriter should use trade references, bank references, credit data, and construction experience résumés in analyzing the construction capability of the general contractor, including financial stability and ability to complete the project.

The underwriter did not record, as required, its use of trade references, bank references, and credit data in analyzing the construction capability of the general contractor. It was clear from the general contractor's résumé that it did not have experience in carrying out rehabilitation projects of this project's size and complexity. The previous work reported did not approach the size and scope of the Cypress Ridge Apartments' rehabilitation project. Its proposed work scope totaled $1.9 million in repairs and included repairs to all 256 units. Whereas, the résumé showed that the general contractor had completed routine management agent jobs on five apartments with total units ranging in number from 104 to 200, with only one job totaling more than 150 units, and repair costs ranging from $285,000 to $785,000. This information did not demonstrate the level of professional general contractor experience needed to carry out the rehabilitation project, which the project outcome affirmed.

As mentioned above, the lender did not obtain income statements from the general contractor. Had the lender requested and reviewed the September 15, 2005 income statement for the same period, it would have seen that the general contractor had no recent construction activity.

From the start, the general contractor did not exhibit sound experience. According to concurrent reviews, it did not follow a logical work plan, review the work scope in detail, and obtain bids. It depended upon the lender and HUD to monitor the construction activity.

As a result, throughout the rehabilitation, the general contractor's efforts exhibited the following deficiencies:

- Absence of a written, organized plan for completing work;
- Lack of an experienced contractor on site to supervise the work, resulting in poor construction;
- Poor workmanship that it had to redo;
- Occupancy of units before required inspections; and
- Change orders that did not follow requirements to provide a full detailed description of the work scope and/or materials, list the units that needed repairs, include materials specifications, provide detailed drawings with the engineers' seal regarding structural review, or clearly explain the required permits.

Conclusion

The lender did not practice due diligence in underwriting the loan to Greystone Apartments, Inc. It did not thoroughly analyze the financial positions of the owner and general contractor and the qualifications of the general contractor as required by the MAP guidelines. Thus, it underwrote and recommended that HUD approve a loan with significant financial and business risk. As a result, the owner defaulted on the loan before final closing, causing HUD a loss of more than $3.7 million.

Recommendation

We recommend that the Acting Director of HUD’s Kansas City multifamily hub

1A. Refer Harry Mortgage Company to the Mortgagee Review Board for appropriate action for violations that caused a more than $3.7 million loss to HUD’s FHA insurance fund.

We recommend that the Acting Director of HUD’s Enforcement Center

1B. Take action against Harry Mortgage Company for negligence that resulted in a default and a resulting FHA insurance claim on Cypress Ridge Apartments.

SCOPE AND METHODOLOGY

The audit covered Harry Mortgage Company's loan processing and underwriting, which occurred during calendar year 2005. To accomplish the objective, we interviewed the lender, the architectural and cost reviewer, and the owner/general contractor. We reviewed background information and criteria controlling underwriting and processing; documents in Greystone Apartments, Inc.'s loan files located in Harry Mortgage Company's office; unaudited financial statements and other financial records of the property, the general contractor, and the key principals of Greystone Apartments, Inc.; property inspection reports; and Cypress Ridge Apartments' rent rolls. We performed the audit from August 2008 to May 2009 at the office of Williams Commercial Property Management, Inc., and the HUD Multifamily Oklahoma City Center office.

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 an integral component of an organization's management that provides reasonable assurance that the following controls are achieved:

- Program operations,
- Relevance and reliability of information,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets and resources.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. They 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 internal controls were not relevant to our audit objectives because Harry Mortgage Company is no longer a going concern. As a result, we did not assess internal controls.

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

Significant Weaknesses

We did not assess internal controls; therefore, no significant weaknesses were identified.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Unreasonable or unnecessary 1/
1A	$3,759,333

1/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that a prudent person would incur in conducting a competitive business.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

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June 17, 2009

Mr. Gerald R. Kirkland
Regional Inspector General for Audit
U.S. Department of Housing and Urban Development
Office of Inspector General, Region VI
819 Taylor Street, Suite 13A09
Fort Worth, Texas 76102

Re: Cypress Ridge Apartments
Oklahoma City, Oklahoma

Dear Mr. Kirkland:

This is in response to the Audit Report Number 2009-FW-100X.

We first want to point out that Harry Mortgage Co. ceased all operations in September, 2007.

Comment 1

1. The auditor alleges that the lender did not obtain sufficient financial information to analyze the financial conditions of the owner or the general contractor. We believe that the auditor did not carefully review what the underwriter reviewed in his recommendations. The underwriter, in this regard, reviewed all the financial statements of all the stockholders involved which showed a gross net worth of $26 million and the experience of Mr. Sharpe that was furnished to us for our review. Without going into a lengthy detailed report of the financial conditions of each shareholder we believe that the project was carefully reviewed and under the circumstances at the time the underwriting took place we would still recommend the loan. As I remarked to the audit committee that met in our office on the 11th of June, hind sight is better than fore sight. Had I known that the work progress would be so slow and unacceptable I certainly would not have recommended the loan to HUD nor would Harry Mortgage have agreed to make the loan.

Comment 2

2. The auditor alleged that the lender did not make a valid determination of the General Contractor's construction capability. We explained to the auditors that we met Mr. Sharpe when he was the project manager for Mr. Larrera and was managing several apartments in Oklahoma City. He had done several rehab projects in the past. Due to the fact that this was a rehab project with no new construction of any kind, we were satisfied that he was capable of doing this project.

Comment 3

Comment 4

Comment 5

All of the underwriter's conclusions were based on the financial statements of all of the parties involved and the resume of the general contractor which listed his past performance and which was convincing evidence to the underwriter that he could complete this project.

All of the information and requirements of the MAP guide were submitted to HUD for their review and upon their review they issued a Firm Commitment apparently agreeing with the underwriter and his conclusions. We therefore take exception to any inferred negligence on the part of Harry Mortgage Co. in lieu of the exhibits that we examined. In our experience of nearly 50 years of underwriting conventional and HUD projects we have concluded that the main reason that a project goes bad is based on the ownership and management of the project.

In conclusion, we want to state that Harry Mortgage Co. in nearly 50 years of submitting loans to FHA, has never intentionally misrepresented any submission to HUD/FHA and although we have now ceased all operations we are proud of our past.

Sincerely,

V. M. Harry, Jr.

Virgil Harry, III

Bobbie Hart

OIG Evaluation of Auditee Comments

Comment 1 According to the response, the lender's underwriter carefully reviewed all the financial statements of the stockholders involved, which showed a gross net worth of $26 million. However, the lender did not dispute the conclusion in the report that its underwriter did not thoroughly analyze the financial conditions of the owner and general contractor as the MAP Guide required. With the two entities not having sufficient working capital, the lender should not have recommended the project to HUD for approval. Under the MAP program, HUD relies heavily on the MAP lender's underwriting in making the decision to approve a project.

Comment 2 The lender stated that it knew the general contractor when he worked as a project manager for a person in Oklahoma City, Oklahoma, that had several apartment complexes. The general contractor reportedly had done several rehabilitation projects for this owner. As discussed in the finding, the general contractor had not performed rehabilitation projects with a similar scope or dollar value as Cypress Ridge. We did not conclude that knowing someone who worked as a project manager for an owner of several apartment complexes constituted reasonable assurance that one has the experience and capabilities to carry out a multimillion-dollar HUD project.

Comment 3 We disagree with the lender as discussed in the finding.

Comment 4 Under the MAP program, HUD relies heavily on the MAP lender's underwriting in making the decision to approve a project. The program does not require HUD to duplicate the underwriting of the MAP lender. The intent of the MAP process is to reduce significantly the amount of HUD review time. Therefore, the expedited process did not allow HUD time to catch a misleading recommendation to approve a project in which the underwriter did not fulfill MAP requirements.

Comment 5 The lender concluded, based on its nearly 50-years of underwriting conventional and HUD projects, ". . . that the main reason that a project goes bad is based on the ownership and management of the project." This statement affirms the importance of the lender's underwriter to assess, as required, the financial wherewithal of the owner and general contractor and the construction capabilities of the general contractor.