



U.S. Department of Agriculture



Office of Inspector General
Western Region

Audit Report

Rural Development
Lender's Origination and Servicing
of a Guaranteed
Rural Rental Housing Loan -
State of Mississippi

Report No. 04601-9-SF
September 2007



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



REPLY TO

ATTN OF: 04601-9-SF

TO: Russell T. Davis
Administrator
Rural Housing Service

THROUGH: John Purcell
Director
Financial Management Division

FROM: Robert W. Young /s/
Assistant Inspector General
for Audit

SUBJECT: Lender's Origination and Servicing of a Guaranteed Loan-State of Mississippi

This report presents the results of our audit of Rural Development's section 538 guaranteed loan program. Your September 11, 2007, response to the draft audit report is included as exhibit B in the report. Excerpts from your response and the Office of Inspector General's positions have been incorporated into the relevant sections of the report.

We agree with your management decisions on Recommendations 2 and 3. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer. Please note that Departmental Regulation 1720-1 requires that final action be taken on the recommendations within 1 year of management decision to prevent being listed in the Department's Performance and Accountability Report. The actions needed to reach management decision for Recommendation 1 are identified in the Findings and Recommendations section of the report.

In accordance with Department Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation of the recommendation for which management decision has not yet been reached. Please note that the regulation requires a management decision to be reached on all recommendations within a maximum of 6 months from report issuance.

We appreciate the cooperation and assistance provided by your staff during the audit.

Executive Summary

Origination and Servicing of a Guaranteed Loan

Results in Brief

This report presents the results of the Office of Inspector General's (OIG) audit of a guaranteed Rural Rental Housing loan issued to Allied Home Mortgage Capital Corporation (Allied or lender) by the Rural Development (RD) Mississippi State Office (SO). The audit was requested by RD because it was concerned that the lender had disbursed approximately 50 percent of the \$5.4 million loan while the borrower failed to construct a single unit on the proposed 90-unit project. The loan was declared in default in August 2004, only six months after RD issued the loan note guarantee, because (a) the project's engineer was concerned that some of the construction completed was sub-standard and would not pass inspection and (b) sufficient loan funds were not available to complete the project. The objective of OIG's review was to determine if the loan was originated and serviced by Allied in accordance with RD regulations and program requirements. Our audit determined that prior to the issuance of the loan note guarantee, Allied did not protect the viability of the project and Allied did not ensure:

- The project's contractor had the required experience and a contractor's license,
- RD's guarantee was in place and construction started with RD's approval,
- The borrower had the financial capability to undertake the project, and
- RD concurred with the projects plans and specifications prior to beginning construction.

After funding the loan, Allied failed to properly service the loan. It did not:

- Have an independent inspector or a staff member review ongoing construction, and
- Obtain and maintain documentation to support the expenses claimed on the request for loan funds.

Our audit concluded that the loan's default and resulting \$2.4 million loss was the direct result of Allied's failure to properly originate and service the loan. Federal regulations state that the guarantee will terminate when the following occurs: fraud, misrepresentation, abuse, negligence, or failure to meet program requirements.¹

¹ 7 CFR § 3565.56 dated January 1, 2003

We discussed the conditions with the senior counsel of Allied² who stated that the former branch manager in Montana was given sole responsibility for originating and servicing the guaranteed loan because of his prior program experience. In November 2003,³ Allied's management assumed the servicing responsibility for the loan after the branch manager left Allied. Shortly thereafter, Allied recognized that the branch manager did not properly service the loan because he did not obtain documentation to ensure that program funds were used for program purposes and verify that the project was being constructed in accordance with plans and specifications.

Allied cannot absolve itself of its responsibility by claiming that their branch manager acted independently. Federal Deposit Insurance Corporation case law has shown that lenders cannot distance themselves from the acts of its employees. Allied is responsible for its agreement with RD, the improper loan origination and negligent servicing, and the loss incurred by the Government.

Recommendations In Brief

We recommend that RD:

- Recover \$2,369,110 from Allied Home Mortgage Capitol Corporation, and any subsequent payments that were made.
- Refer to the Suspension and Debarment Official the administrative record for consideration in initiating suspension and debarment actions against the lender and its branch manager.
- Scrutinize all loan loss claims and transactions involving the lender identified in this report, including its associates or past employees, to ensure that the lender is fully entitled to any loss payment made under the Section 538 guaranteed loan program.

Agency Response

In its September 11, 2007, written response to the draft report, RD agreed with the report findings and recommendations. RD is currently taking steps to recover \$3,300,936.92⁴ from Allied Home Mortgage Capitol Corporation. In July 2007, State Office of Mississippi made an official request to the RD debarment and suspension official for the suspension and debarment of Allied and its branch manager. In addition, RD is closely monitoring the remaining section 538 loans in Allied's portfolio.

² Allied's president referred us to the corporation's senior counsel for all issues related to the subject loan.

³ The branch manager no longer worked for Allied as of November 2003.

⁴ OIG recommended recovery of \$2,369,110, however RD is recovering \$3,300,936.92 because of additional interest expense.

OIG Position

We accept RD's management decision on Recommendations 2 and 3. In order to reach management decision for Recommendation 1, RD must provide us with a copy of the demand letter issued to the lender and evidence that an accounts receivable has been established on the agency's accounting records.

Abbreviations Used in This Report

RD	Rural Development
GRRHP	Guaranteed Rural Rental Housing Program
OIG	Office of Inspector General
NAD	National Appeals Division
SDVG	Superior Development Group

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Background and Objectives

Background

Rural Development (RD) administers programs that are designed to increase affordable, Multi-Family housing in rural America. As part of its mission, RD's Rural Housing Service guarantees a portion of loans that meet its criteria under the Guaranteed Rural Rental Housing Program (GRRHP or the program) for the development of Multi-Family housing in rural areas. Between 2002 and 2004, RD issued construction guarantees for loans totaling over \$68 million.

Allied Home Mortgage Capital Corporation (Allied or lender) is a national mortgage broker and lender which provides residential mortgage loans. On April 26, 2002, Allied signed a lender's agreement with RD, which gave them the authority to process and request loan note guarantees under the program, and required it to originate and service loans in accordance with program regulations and loan covenants.⁵

On August 19, 2002, Allied requested that RD guarantee 90 percent of a \$5.4 million loan for a borrower (Blues Alley Estates Limited Partnership) to build a 90-unit Multi-Family housing project (the Blues Alley Subdivision) in Clarksdale, Mississippi.⁶

On December 9, 2002, RD and Allied signed a conditional commitment wherein the agency agreed to guarantee the loan, pending Allied fulfilling requirements such as ensuring the borrower had acceptable credit, commencing construction upon RD's issuance of the notice to proceed, and verifying that the borrower is in compliance with all regulatory requirements. Allied certified that certain conditions had been met, and agreed to inform RD of any adverse changes.

On February 27, 2003, Allied financed the loan through the issuance of bonds.⁷ Investors purchased a \$4.8 million series A bond and Superior Development Group (SDVG),⁸ the borrower's general partner, purchased a \$537,000 series B bond, using its deferred developer fee.⁹ In accordance with the financing agreement, the proceeds from the sale of the bonds were placed with a trustee, Wells Fargo Bank which was responsible for disbursing funds. However, Allied was still responsible for approving all disbursements of the

⁵ Servicing is defined by actions undertaken by lenders to manage the performance of a loan throughout its term to ensure program compliance.

⁶ For a construction loan, RD can guarantee construction advances up to 90 percent of the work-in-place, or up to 90 percent of the amount actually advanced by the lender, whichever is less.

⁷ OIG plans to assess the propriety of these types of bond transactions in a later review.

⁸ SDVG owns 98 percent of the Blues Alley Estates Limited Partnership (the borrower), and is the contractor of record for the construction.

⁹ Developer fee is the compensation to the developer for time and risk involved to develop a project. It is typically based on the size of the project, total development cost and the risk associated with the project.

guaranteed loan funds, and ensuring that documentation was available to justify each draw request.

Construction on the borrower’s Multi-Family housing project began on April 1, 2003, and draws one through eleven were from March 2003 until May 2004. However, the guarantee was not issued by RD until January 27, 2004, and shortly thereafter, on August 5, 2004, the lender declared the borrower in default and, based on our site visit, none of the 90 proposed units were completed. With approximately \$2.9 (see chart below) of the \$4.9 million expended,¹⁰ the lender terminated the construction project because of the ongoing construction concerns raised by the engineer and the lack of funds available to finish the project.

Major Disbursements for Blues Alley Estates Project	
Disbursements to General Partner for Construction	\$1,089,106
Interest Earned by Bondholders	\$736,548
Cost to Issue Bond	\$415,827
Land	\$319,950
Additional Developer Fees to SDVG	\$108,026
Architect & Engineer Services	\$86,000
Insurance	\$91,205
Legal Fees	\$26,193
USDA Annual Fee	\$12,612
Total	\$2,885,467

On May 19, 2005, RD requested that OIG review the loan. RD expressed concern that loan funds disbursed were not commensurate with the amount of construction completed. OIG agreed to determine if Allied originated and serviced the loan in accordance with program requirements. As part of that determination, OIG agreed to assess how the borrower expended approximately 50 percent of the guaranteed loan funds while failing to construct any of the proposed housing units intended by the loan.

Objectives

The primary objective of our review was to determine if the loan was originated and serviced in accordance with regulations and program requirements.

Details of our audit methodology can be found in the scope and methodology section of this report.

¹⁰ The \$4.8 million series A bond was purchased by investors for \$4.9 million, however, RD only guaranteed \$4.8 million.

Finding and Recommendations

Section 1. Negligent Loan Origination and Servicing

Finding 1

Allied's Loan Origination and Servicing Did Not Comply with RD's Requirements

Allied did not meet program requirements during its origination and servicing of a guaranteed loan. This occurred because the lender gave a branch manager the autonomy to originate and service the guaranteed loan without providing oversight to ensure that program requirements were met. As a result, the lender placed the borrower in non-monetary default within 6 months of RD issuing the loan note guarantee, and the Government paid the guaranteed portion of the loan, totaling \$2.4 million.

According to the lender's senior counsel, the branch manager presented a proposal which would increase their profit, with minimal risk to the lender, by using RD's section 538 program. The senior counsel further stated that the President of Allied agreed with the proposal and allowed the branch manager to administer the program because of his program knowledge. The senior counsel added that since the branch manager had knowledge about the 538 program, the lender's corporate office did not provide any oversight.

Under its Guaranteed Rural Renting Housing Program (GRRHP or the program), RD agreed to guarantee 90 percent of a loan which Allied originated and serviced for a borrower to build 90 Multi-Family housing units. Federal regulations define servicing as the activities undertaken by lenders to manage a loan's performance throughout its term to ensure program compliance,¹¹ while loan origination is the process by which a lender decides whether a potential borrower should receive a loan. The regulations also require lenders to comply with agency rules.¹² Further, the agency can terminate the guarantee when the following occurs; fraud, misrepresentation, abuse, negligence, or failure to meet program requirements.¹³

Allied's senior counsel stated that their files should contain documents that demonstrate that the loan was originated and serviced according to RD's program requirements. The senior counsel added that the lack of documentation would indicate that the loan was not originated and serviced in accordance with program requirements.

¹¹ 7 CFR §3565.3 dated January 1, 2003

¹² 7 CFR §3565.101 dated January 1, 2003

¹³ 7 CFR § 3565.56 dated January 1, 2003

Following are the conditions that we noted during the course of our review.

Allied's Improper Loan Origination

On December 9, 2002, RD signed a conditional commitment with Allied that authorized the agency to issue a 90 percent loan note guarantee to Allied once the terms of the commitment were met. Before receiving RD's loan guarantee, Allied certified that the specific conditions were met or would be met and agreed to follow requirements laid out in RD's program handbook and instructions.

Our audit noted that prior to the loan note guarantee, Allied failed to protect the viability of the project. They did not ensure:

- The project's contractor had the required experience and a contractor's license,
- The RD guarantee was in place and construction started with RD's approval,
- The borrower had the financial capability to undertake the project, and
- RD concurred with the projects plans and specifications prior to beginning construction.

Allied did not Ensure that the Project's Contractor had the Required Experience and a Contractor's License: RD's GRRHP handbook requires lenders to ensure that contractors have experience similar to that needed to complete the proposed project.¹⁴ Further, RD instruction requires that project contractors be properly licensed to undertake their work.¹⁵ Our review of Allied's loan file noted that Allied did not have any documentation to indicate that the contractor had the required experience, history of completing projects of similar size and scope, and a contractor's license.

We spoke with the branch manager who no longer worked for Allied to determine how he concluded that the contractor was appropriately experienced and licensed. He stated that he had used a checklist when verifying the contractor met the experience and licensing requirements. However, when we reviewed the lender's files, we did not find any documentation to indicate that such a checklist was used.

We interviewed the contractor of record who confirmed that he was not a licensed contractor. Subsequently, we also verified

¹⁴ GRRHP Origination and Servicing Handbook 1-3565 §5.4 dated (July 16, 1999)

¹⁵ RD Instruction 1924-A §1924.13(e)(1)(v)(H)(3)(I) (March 16, 1994)

through the Mississippi State Board of Contractors that the contractor was not licensed to do business in the State. Since Allied did not have documentation to indicate that the contractor had the appropriate experience and the required contractor's license, it did not have adequate assurance that the contractor could complete a project of this magnitude.

According to the RD Multi-Family Housing Director, the contractor did not have any other experience as a contractor in Mississippi. She further stated that RD did not have anything to do with the selection of the contractor because this loan was not directly funded by RD. Current regulations place responsibility on the lender to ensure that the contractor is qualified.¹⁶

Allied Did Not Ensure RD's Guarantee was in Place and Started Construction without RD's Approval: The GRRHP handbook requires lenders to issue the loan subject to RD's issuance of the guarantee.¹⁷ Furthermore, RD Instruction requires work to commence on a project once the notice to proceed is issued.¹⁸ However, Allied obtained RD's signed guarantee on January 27, 2004, almost a year after it had issued the loan on February 27, 2003, and allowed the borrower to start construction in April 2003, even though RD did not authorize the issuance of the notice to proceed until March 2004.

The former branch manager stated that the loan was issued because Allied provided to RD certifications which indicated that the terms and conditions in the conditional commitment had been met and the agency assured him that the guarantee was forthcoming. RD's program director in Mississippi, however, said that no such assurances were given to the lender or any of its representatives. We were subsequently informed by the borrower that construction started shortly after the loan was issued because interest was accruing at a rate of approximately \$1,000 per day.

According to the RD Multi-Family Housing Director, it was Allied and their branch manager's responsibility for issuing the loan, not RD. Allied's senior counsel noted that the program required them to obtain the loan note guarantee prior to issuing the loan. He indicated that if its loan files did not contain any information to the contrary, then Allied issued the loan without first obtaining RD's guarantee.

¹⁶ GRRHP Origination and Servicing Handbook 1-3565 §5.4 dated July 16, 1999

¹⁷ GRRHP Origination and Servicing Handbook 1-3565 §4.9 dated July 16, 1999

¹⁸ RD Instruction 1924-A §1924.4 (e) dated March 16, 1994

Allied Did Not Ensure the Borrower had the Financial Capability to Undertake the Project: The GRRHP handbook requires lenders to determine whether borrowers are financially capable of meeting program requirements, which includes determining that borrowers are creditworthy entities,¹⁹ and have the cash and marketable securities needed to close the loan and meet working capital requirements.²⁰ In addition, Federal Regulations state that the lender must certify that the borrower has the legal and financial capacity to meet all obligations of the loan.²¹ These regulations stipulate that the financial capability must be met at the “time of application,” and therefore the use guaranteed loan funds to meet these obligations is not permitted.

The former branch manager stated that he had used the borrower’s financial information to determine that the borrower had met all of these financial conditions. However, the financial information Allied submitted to RD was dated after the loan was issued and included the proceeds from the guaranteed loan.

To portray itself as financially sound, the borrower submitted a Certified Public Accountant’s (CPA) compilation letter (for the period ending September 30, 2002) and substituted its own un-audited balance sheet that the borrower had prepared, dated March 1, 2003 - two days after the loan was issued. In fact, a CPA had prepared a balance sheet for the borrower six months earlier (September 30, 2002), but this information (see table 2) was not submitted to Allied. Table 1 below shows the borrower’s assets from an unaudited balance sheet, which included the guaranteed loan funds as assets.

Table 1: Assets from Balance Sheet Prepared by Borrower

ASSETS: (Balance Sheet Dated March 1, 2003)	
Cash Held in Trust	\$4,839,842
Prepaid Professional Services	142,344
Land	280,000
Development Services	455,762

The “Cash Held in Trust” included approximately \$4.8 million received from the guaranteed loan, making it appear as if the borrower had the financial capability to undertake the project. The “Cash Held in Trust” balance did not establish that the borrower had the financial capability to undertake the project before the guaranteed loan was made. During the course of our review, the borrower and the lender did not present any evidence to indicate

¹⁹ GRRHP Origination and Servicing Handbook 1-3565 §3.5 and §3.6 dated October 30, 2002

²⁰ GRRHP Origination and Servicing Handbook 1-3565 §3.10 (C) dated July 16, 1999

²¹ 7 CFR §3565.153 (b) dated January 1, 2003

that the borrower received any other funds between September 2002 and March 2003.

We obtained the balance sheet compiled by the CPA (dated September 30, 2002), that should have accompanied its compilation letter dated November 5, 2002. The balance sheet showed that the borrower had only \$500 cash four months before the loan was made—which was inadequate to support a \$5.4 million loan. Table 2 below lists the borrower’s assets as of September 30, 2002.

Table 2: Assets from Balance Sheet Prepared by CPA

ASSETS: (Balance Sheet Dated September 30, 2002)	
Cash Deposited Escrow	\$500
Prepaid Professional Services	10,700
Development Service	228,762

The CPA’s November 5, 2002, compilation letter stated that the September 30, 2002 balance sheet lacked information that might influence conclusions about the borrower’s financial position and mislead external users:

[The borrower’s] [m]anagement has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statement, they might influence the user’s conclusions about the Partnership’s financial position. Accordingly, the financial position is not designed for those who are not informed about such matters.

After Allied submitted the March 2003 financial information (Table 1), RD continued to process Allied’s application for the loan note guarantee. On September 8, 2003, RD informed Allied that the agency would not guarantee the loan based in part on its determination that a partner of the borrower was not creditworthy.²² On October 29, 2003, Allied appealed RD’s decision to the National Appeals Division (NAD). To address the concerns identified in the appeal, Allied forwarded to NAD the April 1, 2003, unaudited balance sheet of the borrower’s general partner (SDVG), since it was Allied’s position that creditworthiness should be based on SDVG’s financials not the individual partners. Table 3 shows SDVG’s assets.

²² RD deemed the borrower’s partner “not creditworthy,” in part to, an unacceptable credit history and failure to meet eligibility criteria.

Table 3: Assets from Balance Sheet Prepared by SDVG

ASSETS: (Balance Sheet Dated April 1, 2003)	
Cash and Cash Equivalents	\$819,020
Inventory	25,000
Notes Receivable	436,843
Development Fees Rec.	869,455
Furniture and Equipment	13,560
Intangible Assets	20,289

We believe SDVG's April 1, 2003, balance sheet included proceeds from the guaranteed loan. Although the April 1, 2003, balance sheet did not have explanatory notes, SDVG's unaudited financial statements for the periods ending December 2003 and December 2004 noted that the line item, "Cash and Cash Equivalents," totaling \$819,020, included a bond valued at \$537,000, which was part of the guaranteed loan. SDVG purchased the bond with its deferred developer's fee to meet the 10 percent equity requirement. Since the bond was issued in February 2003, this asset (cash and cash equivalents) was incorporated into the April 1, 2003 balance sheet submitted by SDVG. The lender failed to ensure that the borrower had the financial capacity to undertake the project because the borrower used proceeds from the guaranteed loan to demonstrate that loan obligations were met.

SDVG's financial strength was based in part on its April 1, 2003, financial statement (Table 3), which as mentioned before included proceeds from the guaranteed loan. SDVG's financial capability or creditworthiness was not established before the loan was issued. Without sufficient evidence of the borrower's financial capability, the lender did not have adequate assurance that the borrower would be able to repay the loan.

Allied did not Obtain RD's Written Concurrence with the Project Plans and Specifications Prior to Beginning Construction: The GRRHP handbook requires a lender to provide a copy of the final plans, specifications, and cost estimates, to the Agency for written concurrence by the State Architect.²³ Furthermore, the conditional commitment ²⁴ requires that the RD State Architect provide written concurrence to the final plans and specifications prior to the start of construction.

On April 1, 2003, construction began on the housing project. Allied did not receive RD's written concurrence with the project's plans and specifications until January 22, 2004. We were

²³ GRRHP Origination and Servicing Handbook 1-3565 §5.7 dated July 16, 1999

²⁴ A conditional commitment is a commitment by RD to issue the loan note guarantee once the agreed upon conditions are met.

subsequently informed by the borrower that he had to start construction because the loan had been funded and the interest on the bonds was accruing at approximately \$1,000 a day. By allowing construction to begin without approved plans, the lender jeopardized the viability of the project.

Allied's Improper Loan Servicing

In addition to not complying with RD's prerequisites for receiving its guarantee (see preceding section), Allied improperly serviced the loan by not:

- Having an independent inspector or a staff member review ongoing construction and,
- Obtaining and maintaining documentation to support the expenses claimed on the request for loan funds.

Allied Did Not Have an Independent Inspector or a Staff Member Review Ongoing Construction: The GRRHP handbook requires that actual construction work be inspected by or on behalf of the lender to verify that the terms and conditions of the construction contract are met. This includes verifying that work is being performed in accordance with the approved plans and specifications without deviation. It goes on to state that the lender may use its own staff or the services of a qualified independent fee inspector to periodically inspect the development work to determine whether the construction and land development conform to the drawings and specifications.²⁵

The former branch manager stated that he had contracted with an architect to inspect the construction site and believed that the inspections conducted by the architect were being done on Allied's behalf. However, our review of the lender's file noted that there was not a contractual relationship between the lender and the architect. RD officials did not inspect the site until April 2004.

We interviewed the architect, who stated that he was under contract with the borrower, as a result, he could not have acted as Allied's inspector because he would not have been independent. The architect added that whatever architectural or inspection work that was performed on the project was completed on behalf of the borrower, not the lender. Our review of Allied's file noted that there was a contractual relationship between the borrower and the architect. Without independent inspections conducted on behalf of Allied, there was no assurance that the project was progressing in accordance with plans and specifications.

²⁵ GRRHP Origination and Servicing Handbook 1-3565 §5.10 dated July 16, 1999

In fact, we determined through the course of our review that construction was not progressing in accordance with the engineer's plans. In February 2003, the borrower entered into a contract with a local engineering company. As part of that contract, the engineer was required to provide preliminary drawings and ample inspection to ensure the contractor was constructing the project according to plans and specifications. As construction progressed, the engineer became increasingly concerned about how the sewer and water systems for the project were being built.

On July 17, 2003, approximately three months into construction, the engineer sent a letter that informed the borrower of the amount of work that needed to be done to complete the project as planned. An excerpt of the letter is noted below:

“Water - 96% complete -- The tie in to the City of Clarksdale's water system has not been made, the road bore under the Simmons Road has not been made, and the newly installed water lines have not been tested. . . . And the Sewer - 95% complete – The tie in to the City of Clarksdale's sewer system has not been made, the pressure line across the Women's Clinic has not been installed, and the newly installed sewer lines and manholes have not been tested.”

A month later, the engineer informed the borrower by mail of the requirement to certify to the city that the streets were built according to plans and specifications. This action had to take place before the subdivision plat [sets of plans] could be recorded and before the water, sewer, and streets could be taken over for maintenance by the city.

The following week, the engineer wrote to the borrower again, stating that the water and sewer systems required immediate attention. Before certifying that the systems had been completed according to plans, the engineer requested that additional work be completed on the systems because the water system had not been flushed and pressure tested and the manholes and wet holes ²⁶ had shifted.

The next month, the engineer wrote two more letters to the borrower. The letters iterated that the engineer would not certify that the water and sewer system were completed in accordance with plans until the required tests had been performed.

²⁶ A borehole that traverses a water-bearing formation from which the flow of water is great enough to keep the hole almost full of water.

The week after, the engineer wrote another letter, which stated:

“...the pressure test on the water line has passed; however, the line cannot be accepted until a clear water sample has been returned from the Mississippi Department of Health (September 24, 2003).”

Two weeks later, the engineer’s company wrote a letter to the project’s general partner (SDVG), which repeated the engineer’s position that:

“ . . . In case you are not aware of the engineer’s role in subdivision construction, you cannot obtain building permits without a filed plat [set of plans]. You cannot file the final plat without approval from the City of Clarksdale and the Clarksdale Public Utilities on all infrastructures. They are not going to give you approval without our certification (October 7, 2003).”

Finally, a month later, the engineering company informed the borrower that:

“...all sewer lines, manholes, wet well, force main, and storm sewers have been installed. Portions of the work to date do not meet the plans and specifications and will have to be corrected before we can certify to the construction.”

We spoke with Allied’s senior counsel to determine why the engineer’s concerns, which were in Allied’s files, were not addressed. We informed him that during our review of their files, we did not see any documentation to indicate these concerns were addressed. Allied’s counsel stated that loan servicing was being handled by their staff in Montana and he did not have any reason to question the servicing of the loan. The former branch manager had previously stated that the projects’ architect performed independent inspections on Allied’s behalf. He also pointed out that the architect completed the Application and Certification for Payment form which indicated that he did not have any concerns with the ongoing work.

However, the program handbook requires, in part, that inspections be made prior to each payment to the contractor to confirm the

estimated values of work completed and stored materials.²⁷ We noted that the majority of the disbursement for the 11 draws we reviewed was paid directly to the borrower's general partner, and Allied did not have any inspection reports to indicate that the required onsite construction inspections were completed, or evidence of any review addressing the concerns of the engineer.

In its June 14, 2004, correspondence to RD's area office in Batesville, MS, Allied acknowledged the need to routinely monitor the site: "Allied recognizes the need to have routine on site monitoring of this project to ensure strict adherence to the approved plans and specifications." The response also indicated Allied's intention to hire a certified independent construction inspector to monitor the site in the future, but did not explain why it had not done so in the past. The RD Multi-Family Housing Director stated that the SO did not become aware of the severity of the project's deficiencies until April 2004, when a RD building inspector conducted a site visit.

Our review of the draw requests noted that approximately \$1.1 of the \$2.9 million was disbursed for the purpose of constructing the project. In May 2006, we visited the construction site to see what was completed. During our site visit we noted that only two concrete slabs were poured and some underground utility work was present (see figure one). Since only \$2 million was left for construction and the construction deficiencies were not corrected, the lender did not believe the borrower had adequate funding to finish the 90 unit project, and thus the borrower was put into non-monetary default.

Figure 1: Blues Alley Subdivision (May 2006)



²⁷ GRRHP Origination and Servicing Handbook 1-3565 §5.10 dated July 16, 1999 see manual evidence

Allied did not Obtain and Maintain Documentation to Support the Expenses Claimed on the Draw Down Requests: Federal regulations require lenders to verify the amounts expended prior to each payment.²⁸ Allied’s loan file, however, lacked adequate support for \$868,054 worth of disbursements. Without proper documentation Allied had no assurance that funds were used for program purposes.

For each draw request, the borrower submitted an Application for Certification and Payment to Allied. Allied would review and sign the application, then forward it to the trustee, which held the loan funds to pay the borrower. RD Multi-Family Housing Director informed us that Allied, as the servicing agent, is responsible for ensuring the loan funds are disbursed for program purposes because they issued the loan. We reviewed the 11 disbursements made directly to the borrower’s general partner from March 2003 through May 2004. These disbursements represented 99 percent of the amount disbursed to pay expenses for the construction of the project.

Table 4: Amount of Draws 1-11 Disbursed to General Partner

Draw Number	Date Disbursed	Amount Disbursed	Amount Supported	Unsupported Costs
01	03-11-03	\$74,624	\$0.00	\$74,624
02	04-08-03	83,568	0.00	83,568
03	05-06-03	86,618	0.00	86,618
04	06-19-03	97,290	0.00	97,290
05	07-15-03	68,881	48,696	20,185
06	08-22-03	198,235	1,655	196,580
07	10-10-03	95,372	13,375	81,997
08	11-13-03	183,705	59,500	124,205
09	01-29-04	111,841	27,726	84,117
10	03-23-04	64,911	52,175	12,736
11	05-07-04	24,061	17,925	6,136
Totals		\$1,089,106	\$221,052	\$868,054

Our review of draws 1-11 noted Allied did not have adequate documentation to support expenditures of \$868,054. Furthermore, Allied stated in their July 23, 2004, correspondence to RD that there was “serious deviation in the use of funds disbursed to Blues Alley from what was stated in draw requests submitted to Allied and approved by Allied as the lender.” Allied is responsible for servicing the loan and bears responsibility for failing to obtain adequate support for these draws.

Our audit concluded that Allied did not manage the loan in a reasonably prudent manner to ensure compliance with RD’s requirements and, therefore, negligently serviced the loan. RD’s

²⁸ 7 CFR section §3565.303(c)(3) dated July 16, 1999

lender agreement holds Allied responsible for ensuring that the loan is serviced in accordance with program requirements. RD should recover the guaranteed portion of the loan since current regulations allow the agency to terminate the guarantee if the loan was serviced negligently, or program requirements are not met.²⁹

Furthermore, Federal Deposit Insurance Corporation case law does not permit lenders to distance themselves from the actions of their employees (i.e., “the ostrich defense”). Therefore, Allied cannot absolve itself of its responsibility by claiming that their former branch manager acted independently. Allied’s position that an ex-employee autonomously serviced the loan does not absolve its responsibility for the terms of their agreement with RD. Allied is responsible for the improper loan origination and its negligent loan servicing, and the consequent loss incurred by the Government.

On June 26, 2007, we held an exit conference with representatives from RD to present the results of our audit and obtain the agency’s response. During the conference, agency officials stated that they would submit the administrative record, which contained relevant documentation, to the Suspension and Debarment Official for their consideration in initiating suspension and debarment actions against the lender and its branch manager. Agency officials further stated that they will scrutinize all loan loss claims and transactions involving the lender identified in this report, including its associates or past employees, to ensure that the lender is fully entitled to any loss payment made under the Section 538 guaranteed loan program.

Recommendation No. 1

Recover \$2,369,110 from Allied Home Mortgage Capitol Corporation, and any subsequent payments that were made.

Agency Response. Rural Development is taking steps to recover \$3,300,936.92 from Allied Home Mortgage Capitol Mortgage (“Allied”), which includes all accrued interest and principal payments made to Wells Fargo, the Trustee for the holders of the guarantee on the loan to Blues Alley, L.P. Rural Development sent to Allied a letter requesting the lender to liquidate the collateral for the referenced loan to Blues Alley, L.P. The lender has up to 9 months to liquidate the collateral per 7 CFR 3565 in effect at the time the loan was made. Regardless of the amount collected from liquidation, Rural Development will make every effort to collect the \$3,300,936.92. Rural Development will report the status of these efforts the next quarterly report.

²⁹7 CFR § 3565.56 dated January 1, 2003

OIG Position. We cannot accept RD's management decision. In order to reach management decision, RD needs to provide us with a copy of the demand letter issued to the lender and evidence that an accounts receivable has been established on the agency's accounting records.

Recommendation No. 2

Refer to the Suspension and Debarment Official the administrative record containing relevant documentation for consideration in initiating suspension and debarment actions against the lender and its branch manager.

Agency Response. At the end of July 2007, the State Office of Mississippi made an official request to the Rural Development debarment and suspension official for the suspension and debarment of Allied and its branch manager. Case files were sent from the State Office of Mississippi to the appropriate debarment and suspension official in early August 2007. Since then, the suspension and debarment official has returned the case files to the state office requesting proper identification of events and materials in accordance with procedures before resubmitting them to him. The State Office expects to return the suspension and debarment package to the appropriate official by the end of September 2007.

OIG Position. We accept RD's management decision on the recommendation. For final action, RD needs to provide to OCFO a copy of the referral made to the debarment and suspension official requesting the suspension and debarment of Allied and its branch manager.

Recommendation No. 3

Scrutinize all loan loss claims and transactions involving the lender identified in this report, including its associates or past employees, to ensure that the lender is fully entitled to any loss payment made under the Section 538 guaranteed loan program.

Agency Response. Rural Development is closely monitoring the remaining section 538 loans in the aforementioned lender's portfolio. The loans were all made to one Borrower, who is now in bankruptcy and Rural Development has been working closely with the Bankruptcy Trustee, the Office of General Counsel, and the U.S. Attorney's office regarding the section 538 loans and the plan of reorganization.

OIG Position. RD agreed to closely monitor all of the remaining section 538 loans in the lender's portfolio. Accordingly, we accept RD's management decision and consider this recommendation closed.

Scope and Methodology

We reviewed the loan servicing and origination provided by Allied Home Mortgage Capital Corporation for a \$5.4 million loan made to Blues Alley Estates Limited Partnership to build a 90-unit, Multi-Family housing project in Clarksdale, Mississippi.

To accomplish our objective, we performed fieldwork at RD's national office in Washington, D.C., RD's State office in Jackson, Mississippi, and RD's area office in Batesville, Mississippi. We also visited Allied's corporate office in Houston, Texas, the borrower and engineer in Clarksdale, Mississippi, as well as the actual construction site, and the architect in Memphis, Tennessee. In addition, we interviewed representatives from the City of Clarksdale, and Allied's former branch manager in Kalispell, Montana. We conducted our fieldwork in April and May 2006.

In developing the issues in this report, we performed the following steps and procedures:

- Obtained and reviewed all applicable laws, regulations, and relevant procedures to become familiar with the program,
- Reviewed the 11 disbursements made directly to the borrower's general partner, from March 2003 through May 2004, representing 99% of the amount disbursed to determine if program funds were used for program purposes,
- Interviewed RD national office officials, such as program managers, for background information,
- Reviewed the RD national office file regarding their servicing of the loan,
- Interviewed RD State office personnel, such as the program director and the engineer, for background information on the program and the guaranteed loan in Clarksdale, Mississippi,
- Reviewed RD's State office files for the loan to understand the process and the circumstances surrounding the agency's issuing of the guarantee,
- Interviewed the borrower to understand Allied's loan servicing, and for background information,
- Interviewed the project's engineer and architect, and reviewed their files to understand their roles in relation to the subject loan,
- Interviewed Allied's senior counsel and reviewed the corporation's loan files to understand its role as the servicing agent, and to

determine if it serviced the loan in accordance with program requirements, and

- Interviewed an official from the city of Clarksdale, Mississippi for background information on the loan.

We conducted this performance 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Exhibit A – Summary of Monetary Results

Recommendation Number	Description	Amount	Category
1	Lender violation of program requirements led to a Government loss.	\$2,369,110	Questioned Costs and Loans, Recovery Recommended
Total		\$2,369,110	



**United States Department of Agriculture
Rural Development**

TO: Robert W. Young
Assistant Inspector General for Audit
Office of the Inspector General

SEP 11 2007

THROUGH: John Purcell
Director
Financial Management Division

FROM: Russell T. Davis
Administrator
Housing and Community Facilities Programs

SUBJECT: Report No. 04601-9-SF
Lender's Origination and Servicing of a Guaranteed Loan – State of Mississippi

Below are responses to your recommendations in Report No. 04601-9-SF.

Recommendation No. 1

Recover \$2,369,110 from Allied Home Mortgage Capitol Corporation, and any subsequent payments that were made.

Rural Development's Response to Recommendation No. 1:

Rural Development is taking steps to recover \$3,300,936.92 from Allied Home Mortgage Capitol Mortgage ("Allied"), which includes all accrued interest and principal payments made to Wells Fargo, the Trustee for the holders of the guarantee on the loan to Blues Alley, L.P. Rural Development sent to Allied a letter requesting the lender to liquidate the collateral for the referenced loan to Blues Alley, L.P. The lender has up to 9 months to liquidate the collateral per 7 CFR 3565 in effect at the time the loan was made. Regardless of the amount collected from liquidation, Rural Development will make every effort to collect the \$3,300,936.92. Rural Development will report the status of these efforts the next quarterly report.

Recommendation No. 2

Refer to the Suspension and Debarment Official the administrative record containing relevant documentation for consideration in initiating suspension and debarment actions against the lender and its branch manager.

Rural Development's Response to Recommendation No. 2

At the end of July 2007, the State Office of Mississippi made an official request to the Rural Development debarment and suspension official for the suspension and debarment of Allied and its branch manager. Case files were sent from the State Office of Mississippi to the appropriate debarment and suspension official in early August 2007. Since then, the suspension and debarment official has returned the case files to the state office requesting proper identification of events and materials in accordance with procedures before resubmitting them to him. The State Office expects to return the suspension and debarment package to the appropriate official by the end of September 2007.

Recommendation No. 3

Scrutinize all loan loss claims and transactions involving the lender identified in our report, including its associates or past employees, to ensure that the lender is fully entitled to any loss payment made under the Section 538 guaranteed loan program

Rural Development's Response to Recommendation No. 3

Rural Development is closely monitoring the remaining section 538 loans in the aforementioned lender's portfolio. The loans were all made to one Borrower, who is now in bankruptcy and Rural Development has been working closely with the Bankruptcy Trustee, the Office of General Counsel, and the U.S. Attorney's office regarding the section 538 loans and the plan of reorganization.

Informational copies of this report have been distributed to:

Office of the Chief Financial Officer

Director, Planning and Accountability Division (1)

Government Accountability Office (1)

Office of Management and Budget (1)