Prudential Huntoon Paige Associates, LTD, Arlington, VA

Multifamily Accelerated Processing Program, Amaranth at 544 (Lewisville, TX)

Office of Audit, Region 4
Atlanta, GA

Audit Report Number: 2015-AT-1003
June 30, 2015

To:	Kelly Haines, Director, Fort Worth Multifamily Hub, 6AHML Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB
	//signed//
From:	Nikita N. Irons, Regional Inspector General for Audit, Atlanta Region, 4AGA
Subject:	Prudential Huntoon Paige Associates, LTD, Did Not Underwrite and Process a $19.9 Million Loan in Accordance With HUD Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of Prudential Huntoon Paige Associates' underwriting of a 221(d)(4) project, Amaranth at 544.

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

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

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

Audit Report Number: 2015-AT-1003
Date: June 30, 2015

Prudential Huntoon Paige Associates, LTD, Did Not Underwrite and Process a $19.9 Million Loan in Accordance With HUD Requirements

Highlights

What We Audited and Why

We audited Prudential Huntoon Paige Associates, LTD's underwriting of a $19.9 million mortgage loan to develop Amaranth at 544, a senior multifamily project located in Lewisville, TX. We initiated the review based on the early default, assignment, and significant amount of the project. Our objective was to determine whether Prudential underwrote and processed the loan for Amaranth according to the U.S. Department of Housing and Urban Development's (HUD) requirements.

What We Found

Prudential exposed the Federal Housing Administration (FHA) insurance fund to unnecessary risk and a loss of more than $10 million because it did not underwrite and process the loan for Amaranth in accordance with HUD's guidelines and regulations. Specifically, Prudential did not ensure that adequate cash reserves were provided at loan closing; the appraisal report was supported; the market analysis included support to reflect the present economic conditions; and the project revenue was not overstated. In addition, Prudential failed to obtain support for the borrower's financial capacity.

What We Recommend

We recommend that the Director of the Fort Worth Office of Multifamily Housing Programs refer Prudential to the Mortgagee Review Board to take appropriate action for violations that caused a more than $10 million loss to HUD's FHA insurance fund, or other administrative action as appropriate. Additionally, we recommend that the Departmental Enforcement Center pursue administrative actions, as appropriate, against the responsible party for the material underwriting deficiencies cited in the report.

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Background and Objective

Prudential Huntoon Paige Associates, LTD, is one of the Nation's leading originators of Federal Housing Administration (FHA) multifamily and health care loans with regional offices located throughout the United States. Prudential is a Multifamily Accelerated Processing (MAP)-approved lender that underwrote and processed a section 221(d)(4) loan for the construction of Amaranth at 544 in Lewisville, TX, which consists of 151 units.

Section 221(d)(4) of the National Housing Act authorizes loans to be insured by FHA for the construction, substantial rehabilitation, and purchase or refinancing of multifamily projects. By insuring mortgages, the U.S. Department of Housing and Urban Development (HUD) encourages private lenders (mortgagees) to enter the housing market to provide financing, which otherwise might not be available to owners. Under HUD's MAP program, approved lenders prepare, process, review, and submit loan applications for multifamily mortgage insurance. In accordance with MAP guidelines, the sponsor works with the MAP-approved lender, which submits required exhibits for the preapplication stage. After HUD reviews the exhibits, it either invites the lender to apply for a firm commitment for mortgage insurance or declines the application. For acceptable exhibits, the lender submits the firm commitment application, including a full underwriting package, to HUD to determine whether the loan is an acceptable risk. Considerations include market need, zoning, architectural merits, capabilities of the borrowers, and so forth. If HUD determines that the project meets program requirements, it issues a firm commitment to the lender for mortgage insurance.

In accordance with MAP guidelines and Federal regulations, Prudential is responsible for reviewing all documents submitted to HUD for insurance. The application for Amaranth was submitted in September 2006, with approval granted in March 2007. This project was initially endorsed in July 2007 and finally endorsed in February 2010 for more than $19.9 million. The first principal payment was due in June 2009; however, no principal payments were made on the mortgage. As a result, the loan went into default and was assigned to HUD in August 2010. A claim totaling more than $19.9 million was paid in April 2011, and after assignment to HUD, the loan was included in an August 2011 note sale for $9.7 million, which resulted in a more than $10 million ($19.9 million - $9.7 million) loss to HUD.

HUD's Office of Multifamily Housing Programs is responsible for the overall management, development, direction, and administration of HUD's multifamily housing programs. The Office of Multifamily Housing Development provides direction and oversight for FHA mortgage insurance loan origination, including the implementation of the MAP program.

HUD's Office of Multifamily Housing Programs required Prudential to obtain a project default review of Amaranth from a third-party source. Its purpose was to determine what caused the early default and whether the MAP lender complied with program requirements. Prudential hired a third-party contractor, which reviewed the loan documents and submitted its report on January 13, 2014. However, our audit was separate from this review.

Our objective was to determine whether Prudential underwrote and processed the loan for Amaranth according to HUD's requirements.

Results of Audit

Finding: Prudential Did Not Underwrite and Process a $19.9 Million Loan in Accordance With HUD Requirements

Prudential did not underwrite and process the FHA-insured mortgage loan for Amaranth in accordance with HUD's guidelines and regulations. We identified several underwriting deficiencies, including (1) a lack of sufficient operating deficit reserves, (2) an unsupported and misleading appraisal report (3) unsupported market need and lack of feasibility, (4) overstated project revenue, and (5) a lack of documentation to support the borrower's financial capacity. This condition was caused by Prudential's failure to conduct due diligence, practice prudent underwriting, and conduct a sufficient review of related documents and third-party reports, which HUD relied on. As a result, Prudential exposed the FHA insurance fund to unnecessary risk and a loss of more than $10 million.

Insufficient Reserves Requirement

Prudential did not require the borrower to provide sufficient operating deficit reserves at closing to ensure the ability to maintain the mortgage if operating income was insufficient. Specifically, Prudential's appraiser did not use current market conditions, as required, to estimate the absorption rate used in the calculation of the initial operating deficit reserves[1] and, thus, overstated the absorption rate and allowed the operating reserves to be understated. Specifically, Prudential's appraiser recommended an absorption rate of 9 units per month; however, the immediate market had a current absorption rate of about 4.5 units per month, which was half of the amount proposed.

In addition, Prudential's appraiser included 13 properties to support the market absorption rate; however, 9 of the properties included low-income tax credits, which were not comparable to Amaranth, while 2 of the properties were located outside the market area in Fort Worth, TX, more than 45 miles from Amaranth, and in Bedford, TX, more than 25 miles from Amaranth. The absorption rate is significant in the calculation of the required operating deficit reserves. If a higher absorption rate is used, it would represent a higher amount of units projected to lease every month, which would provide higher projected revenues from leases. By overstating the absorption rate, the monthly revenue would be overstated, thus understating the amount of the operating deficit required by the borrower at closing. Prudential's appraiser was responsible for calculating the operating deficit, including the absorption rate, but understated this amount. However, as the MAP-approved lender, Prudential was responsible for the third-party contractors it hired as well as adequately conducting reviews of third-party reports.[2]

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[1] MAP Guide, Revised 2002, sections 7-14 A.3, 7-10B, and 7-14A
[2] MAP Guide, Revised 2002, sections 11-1, 7-2, 2-10A, and 15-1-A

By using an incorrect absorption rate, the appraiser calculated the operating deficit reserves at closing as $482,507. We recalcualted the operating deficit reserves using an absorption rate of 5 units per month, which was supported by the comparable property located in Lewisville, TX, with an absorption rate of 4.5 units per month. This property was included in the absorption table of Prudential's appraisal report. The recalculated amount totaled $958,636 (see table 1), which was $476,129 more than the amount recommended by Prudential's appraiser. In addition, we determined that the deficit period should have been calculated over a period of more than 20 months instead of the 11 months as calculated by the appraiser. As stated in the MAP Guide,[3] the number of units to be absorbed divided by the monthly absorption rate will yield the total number of months of the operating deficit period. Therefore, if fewer units are absorbed or leased each month, the deficit period will be longer. Since we determined that the absorption rate was only 5, it would take more than 20 months to achieve a break-even occupancy rate.

Table 1: Recalculation of initial operating deficit reserves

	Prudential's appraiser IOD*	OIG recalculated IOD	Difference
Absorption rate	9	5	4
IOD reserves	$482,507	$958,636	$476,129

* IOD=initial operating deficit

Further, this loan included additional risks that Prudential should have mitigated by taking a more conservative approach and requiring additional initial operating deficit reserves to maintain the loan payments if the project revenue was insufficient. The additional risks involved with this loan included unforeseen market changes and construction delays inherent in new construction, longer lease-up periods due to the age restriction associated with senior facilities, and having a borrower with no prior experience with HUD. Prudential was responsible for conducting due diligence to ensure that the borrower had the capacity to maintain the project long term, including sufficient initial operating deficit reserves. For Amaranth, management was unable to lease the units at the proposed rents and had to provide concessions by reducing the rents to increase the occupancy rates. In addition, the market conditions had decreased by the time the units were available for leasing, which also hindered Amaranth's ability to achieve higher occupancy rates and project revenue.

Unsupported and Misleading Appraisal Report

Prudential did not ensure that the appraisal report used for underwriting and approving the loan for Amaranth was supported and adequate. As a MAP-approved lender, Prudential was responsible for hiring third-party contractors such as an appraiser; therefore, it was also responsible for ensuring that the appraiser was prudent and the appraisal included supported and

[3] MAP Guide, Revised 2002, section 7.14, item 3

verifiable information.[4] Prudential signed certifications stating that all in-house, third-party forms, reports, and reviews were reviewed by Prudential in accordance with HUD guidelines. In addition, Prudential's appraiser certified that the appraisal conformed with Uniform Standards of Professional Appraisal Practice. Prudential's appraiser valued the land for Amaranth at $1.6 million, which was unsupported due to vacant land sales not being comparable and unsupported adjustments. More specifically, the inappropriate vacant land sales allowed the land value to be overstated. Further, Prudential's appraiser misled the reader and provided an inaccurate site description.

Unsupported Appraisal

Prudential's appraiser valued the land for Amaranth at $1.6 million, or $10,700 per unit, which we determined was unsupported. Prudential's appraiser failed to make appropriate adjustments to the land sale comparables, included outliers[5] due to location and value, and included a property with incomparable zoning (see table 2). Land sales are used as the basis for determining land value of the subject site, however, the appraiser failed to provide appropriate comparables and adjustments to support the $1.6 million land value for Amaranth, as required[6].

Table 2 illustrates the following determinations made by OIG:

- The appraiser selected an outlier which varied significantly from Amaranth due to its location being inferior to Amaranth's location (see sale 5),

- The appraiser failed to make appropriate adjustments to land sales due to its location and visibility being superior to that of Amaranth (see sales 1 and 6), and

- The appraiser included a property that was an outlier due to value and was not zoned for multifamily housing contrary to MAP requirements (see sale 3) (this sale had the highest price per unit).

[4] MAP Guide, Revised 2002, sections 7-1A and 7-2; Uniform Standards of Professional Appraisal Practice, standard rule 1-2, 2 and 3; and HUD Handbook 4465.1, paragraphs 2-1(a) and 1-8.
[5] An outlier is something that lies outside a reasonable range of numbers (values) and varies significantly from the other data provided.
[6] MAP Guide, Revised 2002, section 7-4, and HUD Handbook 4465.1, section 2-1

Table 2: Land sales used by Prudential's appraiser and OIG's determination

Land sale	Location	Adjusted price per unit	Size (acres)	OIG determined appropriate comparable (yes-no)
1	Lewisville, TX	$5,944	11.708	No – superior location[7] (inappropriate adjustments)
2	North Richland Hills, TX	$6,229	7.394	Yes – appraiser made adjustments for its superiority
3	Irving, TX	$13,318	6.700	No – outlier due to value and not zoned for multifamily housing
4	Lewisville, TX-Amaranth	NA	7.317	NA – subject site
5	Denton, TX	$8,370	25.928	No – outlier due to location
6	Lewisville, TX	$7,000	8.430	No – superior location (inappropriate adjustments)

Based on information available to Prudential's appraiser at the time, we recalculated the land value by excluding inappropriate adjustments and land sales not comparable to the subject property and estimated the amount to be $1.3 million, $300,000 less than the appraised value. Our adjusted price per unit ranged from a low of $4,800 to a high of $8,600 instead of the $10,700 used by Prudential's appraiser. In recalculating the land value, we concluded a value of the vacant site at $8,600 per unit, which was the upper end of the range.

Misleading Site Information

In addition, Prudential's appraiser did not accurately describe the subject site (Amaranth) as required[8], which affected the calculation of the land value. Specifically, the appraiser failed to properly identify and report the relevant characteristics of the subject vacant site as of the date of the appraisal and stated that the site had road access and utilities, which it did not. The appraiser mislead the user of the report as it related to existing road access, infrastructure, and visibility and failed to adjust for these differences in the calculation of the land value. All land sales provided had utilities and road access and frontage, whereas Amaranth did not. The value of the vacant site was a "Hypothetical Condition," which Prudential's appraiser did not disclose or discuss as required.[9] This was a "Hypothetical Condition" because Prudential's appraised value related to the future development of necessary roads, utilities, and other infrastructure for the site. The appraiser's analysis failed to take into consideration the lack of infrastructure.

[7] Properties are rated as having a superior or excellent location if they have access and visibility and are located in an area with ample shopping, grocery, and other facilities, such as medical.
[8] MAP Guide, Revised 2002, section 7-4, and Uniform Standards of Professional Appraisal Practice, standard rule 1-2
[9] Uniform Standards of Professional Appraisal Practice, standard rule 1-2(g), (h), and 2-2

Unsupported Market Need and Lack of Feasibility

Prudential did not underwrite the loan conservatively based on present market conditions. Specifically, it did not ensure that the market analysis included verifiable information and did not support a market need as proposed, which was required.[10] This noncompliance affected the project's feasibility. Specifically, the market study stated that Amaranth was superior to other properties in the market and, thus, warranted higher rents. However, we reviewed the comparable property data and identified that other properties offered the same or similar amenities and in some instances, were located in superior areas as well. Some of the amenities that were similar to those at Amaranth included but were not limited to washers and dryers in units, carports, activity rooms, beauty salons, fitness centers, pools with hot tubs, and elevators. Also, one of the comparable properties (which had the highest rental rates) was located outside the market area by more than 45 miles and was not comparable to Amaranth. It appeared that this comparable was included to support a higher average rent calculation. Prudential's appraiser also included ratings for the comparable properties to support whether they were superior to Amaranth or inferior. Most of the properties were listed as superior to Amaranth but included unsupported adjustments.

In addition, Prudential obtained a default report for Amaranth[11], which identified reasons for the mortgage default. This report listed several issues with the market study. Specifically, it stated that a review of supply and demand characteristics determined that Prudential's appraiser's analysis of demand and supply was not reliable and that the appraisal's growth rate projections significantly exceeded historic trends and did not appear to have support from third-party demographers. Inadequately assessing the market conditions for Amaranth negatively affected the project's long-term feasibility.

Overstated Project Revenue

Prudential overstated the project revenue that Amaranth could achieve, which affected the project's ability to meet its obligations. We reviewed HUD form-92264, HUD Multifamily Appraisal Report, which was included in the loan application, and determined that the proposed rents were not consistent with the current market and comparables included in Prudential's market study and appraisal. Based on our review of the market study, the average rent calculation, as required,[12] supported lower rental rates for Amaranth at the time of development. However, Prudential allowed the higher rents based on unsupported conclusions, thus overstating project revenue the property could achieve. This overstatement placed the project at a disadvantage in its ability to pay a higher mortgage amount and increased the risk of default. Higher rents would support a higher mortgage amount; however, when the rents are overstated in association with a higher mortgage, a default is very likely to occur. Prudential justified the high rents by stating that the project was superior to the current market, which was unsupported.

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[10] MAP Guide, Revised 2002, section 7-5, and HUD Handbook 4465.1, paragraphs 1-8(f) and 1-1(b)
[11] According to HUD's requirements, Prudential obtained a mortgage default review conducted by a third party.
[12] MAP Guide, Revised 2002, section 7-6b

Further, the management company had to provide concessions to reduce the rental rates to lease up Amaranth.

The market study included five comparable properties to support the rent projections for Amaranth. We excluded comparable 5 from our analysis in the table below because it was not comparable to Amaranth and was located more than 45 miles outside the market area (see table 3). This comparable had rental rates for a one-bedroom unit that ranged from $1,455 to $1,595, and the rental rates ranged from $2,200 to $2,300 for a two-bedroom unit. Comparable 4 in Lewisville, TX, was the most similar to Amaranth, offering similar amenities with lower rental rates. Prudential's appraiser acknowledged that comparables 1 and 3 had superior locations by rating these properties as superior to Amaranth, which would require downward adjustments to rent calculations. In addition, comparable 1 also had larger units with amenities similar to those at Amaranth. Therefore, the average rent projections should have been even further reduced.

Table 3: Comparable properties' rental rates

Unit size[13]	Amaranth		Comparable 1 (superior location)		Comparable 2		Comparable 3 (superior location)		Comparable 4	
	Sq. ft.	Rent	Sq. ft.	Rent	Sq. ft.	Rent	Sq. ft.	Rent	Sq. ft.	Rent
1 BR 1 BA	721 754 793 738	$1,175 $1,190 $1,225 $1,185	833 950	$1,280 $1,375	650	$802	650 720	$1,200 $1,380	690 690	$898 $990
2 BR 2 BA	1,042 1,044 1,061 1,090	$1,630 $1,630 $1,640 $1,655	1,059 1,534	$1,790 $2,110	952	$999	850 1,035	$1,520 $1,875	990 990	$1,320 $1,412

Further, Prudential's market study included a chart with the developer's proposed rents, which were significantly lower than those proposed by Prudential's appraiser and used for underwriting (see table 4).

[13] BR stands for bedroom, and BA stands for bath.

Table 4: Developer's and Prudential's proposed rents

Unit size	Sq. ft.	Developer's proposed rents		Prudential's proposed rents	
		Rent	Rent per sq. ft.	Rent	Rent per sq. ft.
1 BR 1 BA	721	$865	$1.20	$1,175	$1.63
	754	$905	$1.20	$1,190	$1.58
	793	$952	$1.20	$1,225	$1.54
	738	$886	$1.20	$1,185	$1.61
2 BR 2 BA	1,042	$1,250	$1.20	$1,630	$1.56
	1,044	$1,253	$1.20	$1,630	$1.56
	1,061	$1,273	$1.20	$1,640	$1.55
	1,090	$1,308	$1.20	$1,655	$1.52

Unsupported Financial Capacity

The borrower's financial statements included $6.9 million in real property, which was included in Amaranth's net worth calculation of $7.9 million; however, Prudential did not conduct due diligence and obtain additional support for the real property. Based on our review of the bank statements, verification of deposits, and credit reports, there was no support or verification for the $6.9 million in real property. Although the loan for Amaranth was fully funded, Prudential should have obtained support and verification for the assets listed on the borrower's financial statements due to the additional risks noted above.

Conclusion

Prudential certified that the MAP application for the FHA-insured loan for Amaranth was prepared and reviewed in accordance with HUD requirements; however, we identified material underwriting deficiencies. Specifically, Amaranth was put at an unreasonable risk of default because Prudential did not conduct a sufficient review of related documents and third-party reports, which HUD relied on for insuring Amaranth's mortgage loan. In addition, Prudential did not obtain adequate support for the third-party reports and the borrower's financial capacity and did not adequately estimate a feasible amount of revenue that the project could sustain or the cash reserves required from the borrower.

HUD placed confidence in Prudential's integrity and competence, but Prudential failed to follow and implement the MAP Guide and other relevant guidance during its underwriting and submission to HUD. As a result, HUD approved a loan with significant financial and business risks. The borrower immediately defaulted on the loan, resulting in a loss to HUD of more than $10 million.

Recommendations

We recommend that the Director of HUD’s Fort Worth Office of Multifamily Housing Programs

1A. Refer Prudential to the Mortgagee Review Board to take appropriate action for violations that caused $10,159,961 in unnecessary or unreasonable cost to HUD’s FHA insurance fund or other administrative action as appropriate.

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

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

Scope and Methodology

We conducted the audit from October 2014 through May 2015 at the HUD office in Fort Worth, TX, Ballard Spahr[14] office in Washington, DC, and Atlanta HUD OIG regional office. The audit covered the period March 2005 through April 2011 and was adjusted as necessary.

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

To accomplish our objective, we reviewed

- Organizational charts effective from March 11, 2005, to April 30, 2011;
- Applicable laws, regulations, and relevant HUD program requirements, including HUD's MAP Guide;
- Prudential's policies and procedures that govern the MAP program related to preparing, processing, and submitting the subject application;
- A list of current and past employees, including job function, date of hire, and date of termination, if applicable, who were directly or indirectly involved with the processing or approval of the loan;
- Prudential's and HUD's project files related to Amaranth, including but not limited to correspondence files, emails, third-party reports, processing and underwriting files, preapplication submissions, firm applications, servicing files, construction, and default activity; and
- General contractor, architect, City of Lewisville, Denton County, and engineer files related to Amaranth, including but not limited to construction plans, contracts, correspondence, land valuation, and draw requests.

We conducted interviews with management agents, the borrower, the architect, general contractors, Prudential employees, and HUD employees.

We also conducted a site visit of Amaranth in January of 2015.

[14] Ballard Spahr was retained by Prudential and appointed as the point of contact for the audit. However, this did not impair our audit or scope.

We determined the loss to the FHA fund to be more than $10 million (the amount of the claim paid, $19,909,961, minus the amount of the note sale – $9,750,000 = $10,159,961).

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

Internal Controls

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

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

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

Relevant Internal Controls

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

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

We assessed the relevant controls identified above.

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

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

Appendixes

Appendix A

Schedule of Questioned Costs

Recommendation number	Unreasonable or unnecessary 1/
1A	$10,159,961

1/ Unreasonable or unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business. We determined the unreasonable cost to be the loss to the FHA fund of $10, 159,961. We determined the loss to the FHA fund to be more than $10 million (the amount of the claim paid, $19,909,961 minus the amount of the note sale – $9,750,000 = $10,159,961).

Appendix B

Auditee Comments and OIG's Evaluation

Evaluation Ref to OIG

Auditee Comments

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May 21, 2015

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Re: Response to HUD Office of Inspector General Draft Audit of Amaranth at 544

Dear Ms. Irons:

This letter is in response to the HUD Office of Inspector General's ("OIG") request that Prudential Huntoon Paige Associates, LLC ("PHP") comment on its May 7, 2015 draft audit report ("Draft Report"). The Draft Report relates to PHP's underwriting of the new construction multifamily housing project known as Amaranth at 544 (the "Project" or "Amaranth") that was financed by a mortgage loan (the "Loan") insured by HUD under Section 221(d)(4) of the National Housing Act. PHP made the Loan under the Multifamily Accelerated Processing ("MAP") Program.

I. INTRODUCTION

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

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

Third, the Draft Report ignores the conclusions of a loan default review ("LQMD Review") conducted by an independent third party, CohnReznick, which concluded that the loan was underwritten to MAP Guide standards, that the appraisal complied with the requirements of the Map Guide and that the appraiser's work on the Market Study complied with the requirements of the Map Guide.

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Finally, the OIG does not analyze or even mention the significant events that caused the Project to fail which were not foreseen by either HUD or PHP and which were beyond their control. For example, as described in more detail below, the Draft Report fails to consider (1) construction related issues which delayed completion of the Project, and the initial lease up, by at least six months; (2) the actions of the Borrower, which according to the LQMD Review include mismanagement and fraudulent activities; or (3) the economic downturn that was simply not predictable at the time that Amaranth was underwritten.

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

Comment 1

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

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

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

The stated objective of the Draft Report is to determine whether the Loan was underwritten and processed in accordance with the Map Guide. Unfortunately, the OIG fails to consider the appropriate provisions of the MAP Guide in its review. For example, the OIG alleges that PHP "did not ensure that the appraisal report was supported and adequate." The OIG explains, among other things, that it believes that PHP should have second-guessed land values and comparables used by the professional appraiser retained by PHP and that PHP should have second-guessed the conclusions in the Market Study. The OIG also invents out of whole cloth an alleged responsibility to confirm assets listed in financial statements that were not required documents in the underwriting of the loan.

The OIG, however, does not cite to any provision of the MAP Guide that would require PHP to substitute its own judgment for that of the retained third-party experts and essentially re-appraise

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the property and conduct the market study anew.[1] The OIG cannot do so, because the requirement does not exist.

The MAP Guide outlines both the qualifications and responsibilities of the Lender and the responsibilities of HUD. Those obligations are found in chapters 8.1, 11.1 and 11.2 of the MAP Guide.

Comment 1

1. Lender Underwriting Qualifications and Responsibilities

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

A. Lender Qualifications

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

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

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

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

As detailed above, the Map Guide does not require that lender's underwriter be a certified appraiser who is qualified to conduct a technical review of the third-party appraisal. Instead, the

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

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MAP Guide requires the lender's underwriter to be a generalist who understands lending practices. A review of the lender's duties during underwriting confirms that conclusion:

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

Comment 1

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

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

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

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

Specifically, section 11.1C of the MAP Guide, requires PHP to (i) review[2] the appraisal report, (ii) hire a well-qualified appraiser, (iii) confirm that the forms were prepared as required by the

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

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MAP Guide, and (iv) conclude, based on the information provided, that the loan presents an acceptable risk to HUD.[3]

2. HUD's Underwriting Responsibilities

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

Comment 1

C. Major Duties and Responsibilities of HUD

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

a. During application underwriting:

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

(2) Performs HUD 2530 Clearance Process.

[3] Section 11.1C provides:

Comment 1

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

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

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

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

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

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

(4) Determines actual financial settlement requirements.

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

Comment 1

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

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

* * *

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> The HUD's review appraisers' technical review should comply with USPAP Standard 3. To document his review, the review appraiser should complete Appendix 7C.1 and the review report must include a signed certification as prescribed by USPAP Standard 3.

Comment 1

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

The HUD review appraiser must document the technical reviews conducted by completing the form located in Appendix 7.C.1 of the Map Guide for the market study and in Appendix 7.C.2 of the Map Guide for the appraisal.

During the pre-application stage the HUD review appraiser must certify, based on the technical review HUD conducted, that the market study:

- complies with the MAP Guide; and
- provides evidence of market need of the proposed number of units/beds and rents;

The HUD review appraiser must also certify that the market rent estimate:

- uses a minimum of three comparables;
- uses comparables that are competitive with the Project;
- identifies and properly adjusts for all services and amenities to be provided;
- provides a narrative explanation for amenity and service adjustments; and
- conforms with the MAP Guide.

See MAP Guide, Appendix 7.C.1.

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At the firm commitment stage the HUD review appraiser must certify, based on the technical review HUD conducted, that:

Comment 1

- the lender's appraiser is a MAP Guide qualified appraiser;
- the appraisal conforms to all the requirements of the MAP Guide;
- the appraisal includes narratives that support all conclusions and estimates;
- the estimated income, total operation expenses, total estimate replacement cost, and the maximum insurable mortgage are acceptable;
- the appraiser estimated an operating deficit period;
- the appraiser calculates the estimated operating deficit based on MAP Guide instructions; and
- the operating deficit calculated is acceptable.

See Map Guide, Appendix 7.C.2.

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

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

Once HUD completes its technical review, Chapter 11.2F obligates HUD to draft a memorandum summarizing the multiple technical reviews of the underwriting package

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(including, among other things, the adequacy of the initial operating deficit) and to determine whether to recommend the loan for approval:

Comment 1

> Upon completion of the technical reviews and the environmental assessment, the Team Leader will prepare a memorandum to the director summarizing the individual reviews of the specialists, any proposed waivers of FHA underwriting requirements and the Team Leader's overall recommendation. The memorandum will specifically address
>
> 1. the adequacy of the initial operating deficit for any new construction or substantial rehabilitation loans . . . .
>
> * * *
>
> Attached to the memorandum will be . . . . specific HUD staff reviews, the Lender narrative summary, the Lender's technical reviews and, if recommended for approval, a proposed FHA Firm Commitment with Forms 92264 and 92264a signed by the HUD reviewers and Team Leader.

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

Comment 1

HUD analyzed the information provided by PHP and determined that it complied with HUD requirements and supported the proposed Loan. HUD reviewed all the information and ultimately decided that the underwriting complied with the MAP Guide and supported the proposed Loan. HUD then concluded that the proposed loan was an acceptable risk to HUD and issued a firm commitment.

Despite both PHP's and HUD's satisfaction of their respective requirements under the MAP Guide, the OIG has in 2015 chosen to second-guess the judgments that PHP and HUD professionals made in 2006 during the underwriting process – judgments that were based on reports of independent, HUD-approved appraisers and analysts.[4]

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

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Comment 2

B. **HUD certified the accuracy and appropriateness of the judgments that the OIG now cites as evidence that PHP did not properly underwrite the Loan**

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

Comment 3

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

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

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

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

While Mr. Doyle expressed his opinion that the market study's demand and supply analysis may have been unreliable, **he concluded that the unreliability was not the fault of the third-party appraiser.** Mr. Doyle noted that the third-party appraiser used M/PF Yieldstar as the source of data for the market study. Mr. Doyle stated:

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

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> It is understood that M/PF Yieldstar is a dominant data base for rental housing in the local market and it is expected and reasonable for an appraiser in this market to use this data. Similarly, it is reasonable for the appraiser to use Claritas, it is one of the most widely used demographic data bases used by appraisers and market analysts thought the United States – the other major demographer is ESRI.

Comment 3

> **Therefore, it does not appear that the appraiser was anything less than rigorous in conducting the standard protocol and methodology in establishing the base line demographic data and rental housing supply. It appears that there could have been mis-information provided to the appraiser from these sources.** (Emphasis added).

Mr. Doyle also noted that "neither the lender nor the appraiser could have predicted that there would be a global economic recession, especially one of the magnitude and longevity that occurred, or have been reasonably expected to factor it into demographic data in 2006." Accordingly, there is no basis to conclude that PHP should have asked the appraiser to revise the market study.

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

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

Comment 4

In addition to the significant flaws identified above, the OIG also failed to consider whether factors other than underwriting caused the default on the Loan. The underwriting, submission, and administration of a HUD-insured loan for the construction of a multi-family project is a complex process involving, among others, numerous third-party professionals and analysts, contractors, a lender, and HUD. In addition, circumstances can change during the development and construction process that cause delays or increase costs. Moreover, market conditions may change during the period between underwriting and occupancy. All of these changes can significantly impact the viability of a Project. If loans like this were risk-free, the HUD insurance program would not be necessary.

Specifically, here, there appeared to be borrower fraud and mismanagement, which the OIG has ignored. Those issues, along with construction delays, ultimately caused the Project's struggles

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and eventual failure. The LQMD Review "concluded that a combination of the following factors contributed to the Project's default:

Comment 4

1. Six-month construction delay, followed by a delayed resolution of a dispute among the Mortgagor, the general contractor, and a subcontractor… [and;]

2. The Mortgagor's mismanagement of initial property operations and fraudulent activities."

The LQMD Review also noted that "[u]pon completion in early 2009, the national housing market had undergone significant changes that could not have been anticipated at the underwriting stage." The OIG completely failed to consider any of those factors.

1. Construction Delays

HUD preliminarily approved four time extension change order requests from the general contractor during construction. Those time extension change orders were later suspended and became a dispute between the borrower, the general contractor, and the utility subcontractor. The original completion target date for the project was July 19, 2008. The Project was not completed until January 23, 2009. Disputes relating to the construction continued to be an issue until February 2010, more than a year after construction was completed. During that time frame the general contractor and various subcontractors and suppliers filed mechanics liens on the property. As noted by CohnReznick, "the delays in construction completion and resolution of the dispute caused significant delay in initial lease-up of the Property and final closing." Those significant delays caused the "Project's initial operating deficit reserve [to be] depleted faster than projected." The construction delays could not have been predicted during underwriting.

Comment 4

The failure of the OIG to consider the effect of the construction delays on the depletion of the initial operating deficit reserve further demonstrates the significant flaws in the OIG's analysis of the underwriting of the Project.

2. Borrower Mismanagement and Fraud

In the LQMD Review, CohnReznick determined that there was evidence of Borrower mismanagement of the property's initial operations as well as fraudulent activities during construction and operations. Specifically, the principals of the mortgagor paid themselves salaries on top of management fees while living rent free on-site. They also paid personal expenses from the Project's operating account. In addition, the borrower made side deals with the general contractor during construction including unapproved changes to the original contract

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documents. Those changes included a commercial grade kitchen in the property's common area[6] and the addition of square footage to a unit that was going to be occupied by the borrower. CohnReznick noted "[T]hese changes were not discussed in the HUD Inspector's reports and discovered only after construction completion." CohnReznick also noted that the property was marketed as an assisted living facility rather than a senior's only apartment complex. Allowing elderly persons in need of care and assistance to live on the property was a violation of HUD requirements and state licensing requirements "consequently, residents in need of medical services had to be located to other facilities, resulting in both lost revenues and unplanned expenses." Those significant borrower fraud related issues were not discussed by the OIG in its analysis. Those were also issues that could not have been predicted during the underwriting of the loan and clearly had a material impact on the leasing up of the Project and the depletion of the initial operating deficit reserve.

Comment 4

[6] During the exit conference the OIG stated that it had visited the Property and that no commercial-grade kitchen existed in the common area. The HUD Representative's Trip Report dated January 23, 2009 at Photo 5: Kitchen, however, clearly depicts that the Property was built with a commercial-grade kitchen:

Comment 5

Photo 5: Kitchen

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3. Global Recession

Comment 3

The Project was underwritten from 2004 through 2006, long before anyone could have predicted that a global economic recession would begin in 2008, two years after approval of the loan by HUD. The OIG's failure to acknowledge that the global recession had an effect on the Project and that it could not have been predicted at the time the Loan was underwritten represents an additional significant flaw in the OIG's analysis.

The OIG's (1) substitution of its own standards in place of the MAP Guide standards, (2) failure to consider HUD's role in reviewing and approving both the underwriting of the Project and the third-party reports at issue, (3) failure to address the findings of CohnReznick, an independent third-party reviewer, that concluded that PHP complied with MAP Guide requirements, and (4) failure to consider the actual causes of the default of the Project demonstrate that the Draft Report is seriously flawed. As set forth in more detail below, the OIG's specific findings are also unsupported.

II. THE PROPOSED OIG FINDING THAT PHP DID NOT UNDERWRITE AND PROCESS A $19.9 MILLION LOAN IN ACCORDANCE WITH HUD REQUIREMENTS IS WRONG

Comment 6

The OIG contends that PHP did not underwrite and process a $19.9 million loan in accordance with HUD requirements and bases that contention on five alleged underwriting deficiencies: (1) an alleged lack of sufficient operating reserves; (2) an allegedly unsupported and misleading appraisal report; (3) an alleged unsupported market need and lack of feasibility; (4) an alleged overstatement of project revenue, and; (5) an alleged lack of documentation to support borrower's financial capacity. The first four of the five contentions that the OIG uses to support its erroneous conclusion are based directly on the appraisal and market report that HUD specifically reviewed and approved, which review and approval, as previously stated, is properly HUD's responsibility. The final contention is based on a complete misunderstanding of the requirements of the MAP Guide as to financial capacity. PHP addresses each of the issues below.

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A. **The Operating Deficit Reserves Requirement was Properly Calculated under the MAP Guide**

Comment 7

The OIG contends that "Prudential did not require the mortgagor to provide sufficient operating deficit reserves at closing to ensure the ability to maintain the mortgage if operating income was insufficient." The OIG makes the contention because it disagrees with the absorption rate concluded to by the third-party appraiser, which according to the OIG, overstated the absorption rate and therefore understated operating reserves. The OIG contends that the appropriate absorption rate should have been 4 units per month as opposed to the 9 units per month concluded by the third-party appraiser.

The OIG attempts to suggest that PHP was "responsible for the third-party contractors it hired as well as adequately conducting reviews of third-party reports." The OIG cites, chapters 11.1, 7.2, 2.10A and 15.1A of the MAP Guide in support of that statement. The OIG's blanket statement that PHP was "responsible" for the third-party contractors is not supported by any of the sections the OIG cites or the MAP Guide as a whole. Section 11.1 has already been discussed in detail above. Two of the other Map Guide sections cited relate to enforcement issues and final section cited only confirms that PHP should hire a qualified appraiser.

For example, chapter 15.1A states:

> By permitting a MAP Lender to prepare much of the documentation for a loan submission for mortgage insurance, HUD places confidence in the Lender's integrity and competence. HUD and MAP Lenders have a mutual interest in ensuring consistent Lender competence and compliance with the MAP Guide and other relevant guidance and handbooks. If in the process of performing this work, the Lender places HUD at risk, HUD needs to issue a Warning Letter or sanction the Lender as quickly as possible.

Chapter 2.10A similarly states:

> By authorizing a MAP Lender to prepare much of the documentation for a loan submission for mortgage insurance, HUD places confidence in the Lender's integrity and competence. If in the process of performing this work, the Lender places HUD at risk, HUD needs to terminate the Lender's authority to use the MAP process as quickly as possible. If a Lender's authority to use MAP is terminated, the Lender may still have loan applications for mortgage insurance processed in the traditional way by HUD staff.

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Obviously, neither of those sections states that the Lender is responsible for the content of a third-party report. In fact, neither section even relates to underwriting. Chapter 15 is the administrative remedies section of the MAP Guide and chapter 2 describes general qualifications of a lender.

Comment 7

Chapter 7.2 of the MAP Guide states, in relevant part:

> The MAP Lender is responsible for the selection, approval, and training (if needed) of appraisers and market analysts who are familiar with HUD reviews and guidelines. Lenders must ensure that each appraiser and market analyst selected is qualified to appraise or perform market analyses for multifamily properties by reviewing their education, quality, and frequency of multifamily experience, sample appraisals and market studies, professional affiliations, and state licenses or certifications.
>
> * * *
>
> C. The Department reserves the right to examine the credentials of all appraisers and market analysts hired by the Lender, and to reject any and all individuals that it considers unqualified.

Chapter 7.2 also does not support the OIG's position. The chapter states that a Lender is responsible for selecting a qualified appraiser, not that a Lender is responsible for the content of any specific appraisal. Tellingly, the same chapter further highlights HUD's oversight function as it specifically provides HUD the opportunity to reject any appraiser or market analyst that HUD considers unqualified.

In this case, the appraisal and market study were prepared by individuals who were more than qualified to prepare the reports. At the time the appraisal and market study were completed in June 2006, the appraisers had 38 years of combined experience in appraising commercial properties, including multifamily projects. In fact, the appraisers had a substantial history of providing appraisals to lenders and to HUD. Both appraisers were licensed in the State of Texas and were otherwise credentialed in appraising real estate. PHP had prior experience with the appraisal firm and found its work product to be in compliance with the MAP Guide and other HUD requirements. HUD neither questioned nor rejected the selection of the appraisers. Accordingly PHP fulfilled its obligations under the MAP Guide.

Chapter 11.1.C. states that the lender must certify that it has reviewed all third-party reports, that the reports were prepared by qualified individuals and that they were prepared as required by the

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MAP Guide. When read in conjunction with chapter 11.2, relevant portions of which are discussed in section I, above, it is clear that HUD is responsible for reviewing the third party reports to assure that they are "free of errors and…omissions." The OIG's inapposite citations, therefore, further demonstrate the significant flaws in the OIG's analysis and that the OIG is stretching and reaching to create lender responsibilities that do not exist under the MAP Guide, especially when considered in conjunction with the LQMD Review finding that "the Lender's underwriting documentation generally satisfied the reporting requirements of the MAP Guide."

Comment 7

A review of the OIG's specific contentions with respect to absorption rate further demonstrates the flaws in the OIG's position. The OIG has not and cannot demonstrate that the appraiser's absorption analysis was wrong at the time the appraiser conducted the analysis. The OIG can only demonstrate that its own appraiser, conducting a similar analysis almost 10 years after the fact, has a different opinion.

For example, the OIG contends that "the immediate market had a current absorption rate of about 4 units per month". While, the appraiser identified the one seniors apartment complex in the Primary Market Area ("PMA") with an absorption rate of 4.5 units per month, that one seniors apartment complex in the PMA was constructed in 2002, was in an inferior location and had an inferior design in that it had out buildings as opposed to the single building design of the Project which is reported to be more desirable to seniors. The 4 unit absorption rate posited by the OIG, therefore, appears too low even if only that one complex is considered.

The third-party appraiser retained by PHP also analyzed four market rate seniors' apartment projects when concluding an absorption rate. The four purely market rate seniors apartment projects reported absorption rates of 10.5, 8.9, 3.3 and 4.5 units per month averaging 6.8 units per month, a rate higher than that posited by the OIG.

Of the 13 total projects considered by the third-party appraiser retained by PHP, 10 were seniors' projects. Those projects reported absorption rates of 10.5, 8.9, 3.3, 4.5, 9.0, 14.0, 13.0, 8.1, 35.0 and 13.0, averaging 11.93 units per month. If one ignores the 35.0 unit per month outlier, the average absorption rate for those projects is 9.4 units per month, which is much higher than the OIG's suggested rate.

Finally, calculating a reasonable absorption rate, while primarily based on historical data, is also dependent on other data. The most recently constructed senior's apartment comparable considered by the third-party appraiser retained by PHP was Franklin Park at Cityview which was constructed in 2004 and leased at an absorption rate of 8.9 units per month, again, a number higher than the OIG's suggested rate.

The OIG can point to no appraisal standards that prohibit the third-party appraiser PHP retained from using its professional judgment to analyze a myriad of relevant factors to analyze and reach

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a reasoned opinion on an appropriate absorption rate. Without that prohibition, the OIG appraiser's absorption rate calculation is just a different absorption rate opinion. PHP and HUD, therefore, had the right, back in 2006, to depend on the absorption forecast provided by the third-party appraiser retained by PHP and approved by HUD. The Initial Operating Deficit of $482,507.00, therefore, was properly calculated under HUD's formula as equal to four months of debt service. That calculation was reviewed and approved by HUD utilizing USPAP technical review standards as required by MAP Guide Chapter 11.2F and Appendix 7.C.2.

B. The Appraisal Report Complied with the MAP Guide Requirements

Comment 8

The OIG contends that PHPs underwriting of Amaranth was deficient because the appraisal was allegedly unsupported and contained misleading site information. Again, the OIG is wrong. The appraisal complied with MAP Guide requirements, the land value concluded by the appraiser was not inappropriate and the site information provided by the appraiser was appropriate.

1. HUD and the LQMD Report both concluded that the appraisal complied with MAP Guide requirements

As noted in Section I, above, CohnReznick, utilizing a certified appraiser, concluded that the appraisal conducted by the third-party appraiser for the Project complied with MAP Guide requirements and USPAP standards. As also noted above, HUD reviewed and approved the same appraisal and certified that it complied with Map Guide requirements and USPAP standards.

2. The appraisal was properly supported as required by the Map Guide

The OIG alleges that the land value concluded in the appraisal was not properly supported. As with the absorption rate calculation discussed above, the OIG's position amounts to a difference of opinion between the Amaranth appraiser and the OIG's appraiser. Moreover, as noted in the LQMD Review, "land value represents a nominal fraction of the Total Development Cost and the margin of error herein would not significantly influence the overall estimate of market value or the loan amount."

Nevertheless, the OIG takes issue with the land value calculation and seeks to recalculate land value by excluding certain adjustments and land sales. The OIG provides only a conclusory chart with notations of "yes" or "no" as to whether it believed a sale was comparable. The OIG then opines that ten years ago the land was worth $1.3 million and not $1.6 million. As with the absorption rate calculation, the OIG points to no appraisal requirements or standards that would dictate the changes that the OIG chose to make. The OIG simply likes its number better than the one concluded by the third party appraisers who had over 38 years of combined experience in valuing property in the State of Texas.

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Comment 8

3. **The site information was appropriate**

The OIG states that the third-party appraiser assumed utilities and road access to the construction site even though, according to the OIG, the roads and utilities did not yet exist. According to the OIG, the methodology utilized by the third-party appraiser utilized a "hypothetical condition" which must be disclosed in the appraisal. The OIG wrongly asserts that the appraiser failed to disclose the hypothetical condition. Page 6 of the appraisal states, in relevant part, that the purpose of the appraisal was to estimate "Market Value of the fee simple interest in the vacant land, 'fully improved,' (ready for development to its highest and best use)." Page 13 of the appraisal further states:

Hypothetical Condition

- The subject property is proposed and has an anticipated completion date of November 2007; lease-up is anticipated to occur during the final stages of construction with the subject reaching stabilized occupancy by December 2008. However, for purposes of this analysis, the subject is assumed to be "completed and stabilized" as of the effective date of this report, June 12, 2006.

Accordingly, the OIG is incorrect in its assertions relating to the appraisal.

C. **The Market Study Demonstrated Market Need and Feasibility**

Comment 9

The OIG contends that PHP did not "underwrite the loan conservatively based on present market conditions. Specifically, it did not ensure that the market analysis included verifiable information and did not support a market need as proposed, which was required." Again, the OIG invents requirements which are not in the MAP Guide. PHP was not required to underwrite Amaranth "conservatively," a term which the OIG does not define; it was required to underwrite the loan pursuant to the requirements of the MAP Guide. As noted throughout this response, PHP did so as was recognized and certified by HUD when the loan was underwritten and as was confirmed by the LQMD Review.

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Comment 9

With respect to the market study, the MAP Guide at chapter 7.5, "Market Study Requirements," provides:

> Each market study must meet the following requirements:
>
> A. Be prepared for the Lender and paid for and initiated by the Lender. A market study that has already been prepared for the borrower by a third party market analyst and meets all other market study elements as stated in the MAP Guide is acceptable.
>
> B. Adequately describe the geographic boundaries and general characteristics of the market area, specific housing market conditions, characteristics of projects under construction and in the planning stages, and contain a demand estimate and analysis and estimated absorption time (absorption time is normally not applicable to refinance and purchase cases pursuant to Section 223(f)).
>
> C. Have an effective date within 120 days before the date the pre-application is delivered by the Lender to HUD or within 120 days before the Firm Commitment application is delivered for a 232/223(f).
>
> D. Be prepared with the list of information supplied by the MAP Lender described in Appendix 4.
>
> E. Be prepared in conformance to the market study format found in Appendix 7A.
>
> F. Both the appraiser and market analyst may be the same person or entity. If the same person does prepare the market study, it must be submitted as an independent exhibit.
>
> G. Include market analyst's certification. See certification format in Chapter 11 of MAP Guide.

The Amaranth market study prepared by the third-party appraiser complied with those requirements. The market conditions at the time of the combined market study and appraisal dated June 12, 2006 were adequately described in the report. The appraiser expressed in detail

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the trends in rents, occupancy, jobs creation for the Dallas/Ft. Worth metropolitan area, Dallas alone, Ft. Worth alone and the PMA that included Lewisville, Flower Mound, Carrollton, Addison and Farmers Branch. The demographic data was taken from Claritas, a nationally recognized and utilized demographic data provider and the US Census. The appraiser also tapped more local market data from M/PF YieldStar and other local providers. As noted by the LQMD Review, to the extent there was any problem with the market study, it was due to faulty data provided by M/PF YieldStar, the "dominant" data base provider for the local area and by Claritas, "one of the two most widely used demographic data bases used by appraisers and market analysts throughout the United States." The third-party provider correctly utilized what it, and everyone else at the time, thought were reliable data bases.

Comment 9

The OIG's criticism of the Market Study relates very generally, and with very little support to three differences of opinion. First, the OIG contends that the Amaranth property was not superior to the other comparable properties identified in the market study. Second, the OIG opines that one of the comparable properties was over 45 miles away from the Amaranth site. Finally, the OIG cites the LQMD Review for the proposition that the supply and demand characteristics in the third-party report were not reliable, without noting the CohnReznick conclusion that the reliability issue was not the fault of the appraiser, whose work was "rigorous."

Comment 9

The third-party appraiser opined that the Amaranth property was superior to others in the area and therefore would support higher rents. The OIG responds that some of the other properties used as comparables had similar amenities and were also in superior areas. The OIG does not address the fact that those properties were built several years before Amaranth and were therefore older, or that some of the properties were designed with outbuildings rather than as a single, integrated building, which is a superior design feature. The OIG's criticism represents yet again, a difference of opinion and not any identified violation of any provisions of the MAP Guide.

The OIG's contention that one comparable property (with the highest rental rates) should not have been considered because it was "located outside the market area by more than 45 miles and was not comparable to Amaranth" is factually incorrect. The property at issue, Franklin Park at City View was within the subject's metropolitan area. Moreover, demographic and market data for the subject's metropolitan area was provided in the report. Significantly, the OIG does not define what it considers the "market area" to be for the Amaranth property or why the property would not draw residents from the metropolitan area at issue. Most importantly, the OIG does not identify a single provision of the MAP Guide or any other authority that would preclude the consideration of the property at issue as a relevant comparable.

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Finally, the OIG criticizes in very general terms the supply and demand characteristics of the market study by referring to the LQMD Review.[7] The LQMD Review recognizes however, that "in 2006, neither the appraiser nor the lender could have predicted that there would be a global economic recession, especially one of the magnitude and longevity that occurred, or have reasonably expected to factor it into demographic data in 2006."

Comment 10

D. Project Revenue was Calculated as Required by the MAP Guide

The OIG continues its criticism of the third-party appraisal by stating that the proposed rents in the appraisal were higher than the OIG believes were appropriate. As with its other criticisms, the OIG does not identify any section of the MAP Guide that would support its opinion over that of the appraiser.

A review of the appraiser's conclusions, however demonstrates that the estimated project revenue for Amaranth was not overstated. As demonstrated by the below chart, project revenue was based on the appraiser's market rents which were well within the 60% range posited by MAP Guide Chapter 7.6B.

Subject – Appraiser's Projected Rents			Comparables – Adjusted Rents per 92273's		
				Adjusted Rents	60% Range
1 bd/1 ba	721 sq. ft.	$1,175	1 bd/1 ba	$858 - $1,511	$989 - $1,380
1 bd/1 ba	738 sq. ft.	$1,185	1 bd/1 ba	$866 - $1,520	$997 - $1,389
1 bd/1 ba	754 sq. ft.	$1,190	1 bd/1 ba	$874 - $1,528	$1,005 - $1,397
1 bd/1 ba	793 sq. ft.	$1,225	1 bd/1 ba	$894 - $1,576	$1,030 - $1,400
2 bd/2 ba	1,042 sq. ft.	$1,630	2 bd/2 ba	$1,064 - $2,108	$1,273 - $1,899
2 bd/2 ba	1,044 sq. ft.	$1,630	2 bd/2 ba	$1,065 - $2,109	$1,274 - $1,900
2 bd/2 ba	1,061 sq. ft.	$1,640	2 bd/2 ba	$1,074 - $2,117	$1,283 - $1,908
2 bd/2 ba	1,090 sq. ft.	$1,665	2 bd/2 ba	$1,088 - $2,132	$1,297 - $1,923

The OIG's proposed adjustment of projected rents appears to be entirely based on its opinion that the Franklin Park at City View property should not have been considered a comparable property, an issue PHP has already addressed in this response.

[7] The OIG implies that the LQMD Review identifies several flaws in the market study as leading to the Amaranth default. The OIG is wrong. As previously noted, the LQMD Review specifically identifies the causes of the default as construction delays, mismanagement by the borrower, and borrower fraud, issues that the OIG completely ignores in the Draft Report.

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Comment 11

E. The MAP Guide Does Not Require Verification of Real Estate Listed in Personal Financial Statements

The OIG's final criticism is that PHP should have verified the real estate assets identified on the financial statements of the Project's principals. The OIG cites absolutely no provision of the MAP Guide in support of its position because the requirement does not exist.

Sections 8.3.A.2. and 4. of the MAP Guide state:

> The Lender's underwriter must:
>
> 2. Analyze the credit worthiness of the principal sponsors, the mortgagor entity, if formed, and the contractor.
>
> ***
>
> 4. Determine the financial capability of the mortgagor and the general contractor.

Sections 8.4.C.2. and 3. of the Map Guide state:

> 2. A mortgagor entity with adequate capital does not require financial statements of the individual ownership interest(s). The mortgagor entity must be fully funded in an account in the name of the mortgagor entity.
>
> 3. A working capital determination is to be made by the Lender's underwriter for the mortgagor and the general contractor from a review of the financial statements. Working capital is the excess of current assets over current liabilities. The net working capital is to be adjusted for the effects of contingent liabilities and the financial needs of other projects in the planning stage or under construction adjusted by the percentage of completion.

The mortgagor for the project was Amaranth II, LP. The principals were Carmelita and Winifredo Dolores. As required in the MAP Guide, PHP analyzed the creditworthiness of the principal sponsors, the mortgagor entity and the contractor. It pulled credit reports for each of those entities as part of its analysis.

As required in the MAP Guide, PHP looked at the financial capability of the mortgagor – Amaranth II, LP. MAP Guide 8.3.A.4. The mortgagor was a newly formed entity with no financial or credit history. The working capital and operating deficit escrows, however, were

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fully funded with the money needed to close through the posting of letters of credit. The fact that the mortgagor was fully funded is evidenced through the closing statement which shows a credit of $356,136.36 to the Mortgagor. Because the mortgagor was fully funded, financial statements of the principals - Carmelita and Winifredo Dolores - were not required. MAP Guide 8.4.C.2. PHP had verified that the required money existed within the Project to cover expenses as underwritten.

Comment 11

Despite the fact that the financial statements of Carmelita and Winifredo Dolores were not required by the MAP Guide, PHP obtained their sworn financial statements. PHP also obtained deposit verifications from financial institutions confirming over $1,000,000 in cash deposits.

In addition, the financial statements were certified by the principals and false statements by the principals are punishable by criminal and civil penalties. As a result, both the Lender and HUD are entitled to rely on those sworn statements (especially, since cash balances had been verified). The OIG does not suggest that the real estate assets listed on the financial statements do not exist. The OIG also does not and cannot suggest PHP or HUD could have somehow required the principals to use their money or other assets to keep the Project from defaulting. The principals were not the borrowers and were not required to provide additional funding beyond that required in the underwriting. The OIG's position, therefore, is just another in a long list of opinions in its Draft Report, and one of the most obvious examples that the OIG's Draft Report fails to meet its stated objective of "whether Prudential underwrote and processed the loan for Amaranth according to HUD's requirements."

III. CONCLUSION

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

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

In addition, CohnReznick concluded in its default review of the Project that PHP had complied with its underwriting obligations under the MAP Guide. The report further concluded that the third-party appraisal complied with the MAP Guide and with USPAP standards. The report also acknowledged that the global recession which began almost two years after Amaranth was submitted to HUD could not have been anticipated in the third-party market study. Finally, the

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CohnReznick report concluded that the Amaranth default occurred due to construction delays, borrower mismanagement and borrower fraud.

Unfortunately, the OIG has chosen to ignore CohnReznick's warnings about potential borrower fraud. Instead, the OIG has issued a report that second-guesses the reasoned opinions of qualified third-party appraisers almost 10 years after the fact and with the benefit of 20/20 hindsight, that ignores the approval of those reports and opinions by HUD, that ignores the CohnReznick report, that seeks to place obligations on PHP that do not exist in the MAP Guide, and that ignores the very terms of the MAP Guide. The OIG's Draft report is fatally flawed and should be withdrawn.

Sincerely,

Constantinos G. Panagopoulos

OIG Evaluation of Auditee Comments

Comment 1 Prudential's comments state that OIG has ignored the requirements of the MAP Guide and is improperly substituting its own judgment as to how the Amaranth loan should have been underwritten. Prudential also stated that OIG failed to consider the MAP Guide in relation to its audit objective and believes that Prudential should have second-guessed the conclusions in both the appraisal and the market study. In addition, Prudential's comments state that OIG alleged a responsibility of Prudential to confirm assets listed on the financial statements that were not required. Prudential's comments included extensive criteria for HUD's responsibilities in the underwriting process.

However, OIG used the criteria in the MAP Guide to review what the lender did versus what the requirements state. Prudential has specific responsibilities, such as conducting a sufficient review of all loan documents submitted to HUD for review, which OIG determined did not occur. Although HUD approved the loan, Prudential was responsible for reviewing the documents to ensure compliance with the requirements and that the loan presented an acceptable risk, which it did not. Based on the MAP Guide, Revised 2002, paragraph 15-1(A), HUD places confidence in the Lender's integrity and competence, thus relying on the documents provided by Prudential. The audit objective was to determine whether the loan was underwritten and processed in accordance with HUD guidelines, including but not limited to the MAP Guide. The report cites all related requirements to support the findings in the footnotes.

OIG did not state that Prudential should have second-guessed the appraiser but, rather, that it was required to conduct a review of the appraisal and market study report to ensure compliance as required by the MAP Guide. OIG's review identified that the appraisal and market study submitted to HUD did not comply with the requirements and did not include the information required. In addition to the criteria already cited in the report, the MAP Guide, Revised 2002, paragraph 1-4(C)(5), states that for the firm commitment application, the lender performs a complete underwriting of the application, including an architectural review, a cost review, and a review of the appraisal. Further, Prudential certified that third-party reports, including the appraisal and market study, were reviewed to ensure compliance with requirements and that they were accurate and complete. Prudential should have conducted a review sufficient to certify that the third-party reports were in compliance. Paragraph 7-9(B) also lists the responsibilities of the lender.

Regarding the assets on the financial statements, the audit report stated that Prudential "should" have obtained support for the assets to be prudent in its underwriting practices. Thus, OIG did not conclude that Prudential was required to obtain support but, rather, that it was required to practice due diligence and prudent underwriting practices (MAP Guide, paragraphs 11-1(C) and 15-3(A)(6)).

Comment 2 Prudential's comments state that HUD certified the accuracy and appropriateness of the judgments that OIG cites as evidence that Prudential did not properly underwrite the loan. However, Prudential has the responsibility to conduct a review before submitting the loan to HUD including certifying that the loan is in accordance with HUD guidelines and presents an acceptable risk to the Department, which it did not. See comment 1 above.

Comment 3 Prudential's comments state that an independent reviewer concluded that Prudential complied with MAP Guide requirements while underwriting the loan for Amaranth. Prudential also stated that the independent reviewer included in its report that the unreliability of data in the appraisal and market study was not the fault of the third-party appraiser and it appeared that the appraiser may have been misinformed. Prudential's comments state that the independent reviewer included the fact that neither the lender nor the appraiser could have predicted the global economic recession that occurred after the underwriting of the loan.

However, OIG reviewed the independent reviewer's report as part of the audit and noted the conclusions in the audit report as they related to the objective and findings. The independent reviewer stated that the report generally satisfied the requirements but that the supply and demand analysis was not reliable and growth rate projections exceeded historic trends and did not appear to have support from third-party demographers as stated in the audit report. These statistics were ultimately used by Prudential to justify a market need and feasibility for the project and later approval; therefore, they should have been reliable and supported.

The independent reviewer further stated that the increased growth rate may have been due to the temporary relocation of displaced Hurricane Katrina victims and included various questions and discrepancies with Prudential's appraisal report, including but not limited to turnover rates, supply projections, and conflicting conclusions. Despite the various discrepancies identified, the independent reviewer stated that it "appeared" that the appraiser could have been misinformed, which does not exclude the appraiser from providing a supported and accurate appraisal as well as practicing due diligence and using reliable information. Prudential's appraiser also certified that the appraisal met HUD and Uniform Standards of Professional Appraisal Practice requirements. OIG's review was conducted based on the information provided at the time of underwriting and did not suggest that Prudential should have been able to predict the economic recession that occurred after the underwriting of the loan. OIG concluded that the loan was not feasible at the time of underwriting based on the underwriting and not the change in the economy, which occurred after the initial endorsement.

Comment 4 Prudential's comments state that OIG failed to consider factors, other than underwriting, that led to Amaranth's default, including construction delays, borrower (principal) mismanagement and fraud, and the global recession. However, the objective of the audit was to determine whether Prudential underwrote and processed the loan according to requirements, which the audit determined it did not. All loans, including new construction, involve risks, including construction delays, that the lender is required to document in the underwriting narrative and mitigate as required in MAP Guide, Revised 2002, paragraph 11-1(B).

In addition, Prudential stated that OIG ignored the alleged borrower fraud and mismanagement by the principals on behalf of the borrower, which was mentioned in the third-party default report. However, OIG conducted extensive audit work to try to substantiate the allegations included in the report, as discussed below, but was not able to obtain support. Further, these issues occurred after the underwriting conducted by Prudential, which was the focus of the audit. With respect to the borrower mismanagement, OIG documented that the borrower had no prior experience with HUD programs, which was a significant risk and known at underwriting, and during an interview, the principal of the borrower stated that the requirements were not made clear by Prudential or HUD until something went wrong.

Specifically, the allegations of fraud stated that the principals of the borrower occupied a unit free of rent, without prior approval from HUD or Prudential, and upgraded the unit. During OIG's site visit to Amaranth, it was able to verify that no upgrades had been made to the occupied unit and that the principals brought in personal appliances to use in the unit. In addition, OIG obtained an email from Prudential, which stated that Prudential was aware that the principals would live in the property and did not include rent for this unit. Once HUD informed the principals that they were unable to reside in the property, they moved back to their private residence and removed their personal appliances.

Another allegation of fraud and mismanagement was that the principals of the borrower paid themselves management fees on top of salaries. However, during the audit, OIG reviewed the monthly accounting reports during the time the principals managed Amaranth and determined they did not collect a management fee. OIG also interviewed one of the principals, who stated HUD told them they could not collect management fees; therefore, they did not do so. The principal stated that they completed maintenance work and collected salaries for this work. OIG also obtained a letter from HUD that included several questioned costs and required repayment from the principals.

The third-party report also alleged that the principals marketed Amaranth as assisted living, which OIG was able to discuss with the subsequent management agent. The management agent stated that the principals marketed Amaranth to emphasize amenities similar to those of an assisted living facility, such as including meal service, which were also provided at several comparable properties for an additional fee. However, the management agent, as well as monthly reports, confirmed that Amaranth had extremely low occupancy rates and troubles leasing up. Prudential did not provide support to show that residents requiring medical assistance were moved in and the amount of alleged lost revenues. However, Amaranth was already suffering from lost revenues due to the inadequate occupancy.

Comment 5 Prudential's comments state that during the exit conference, OIG stated that it had visited Amaranth and that no commercial-grade kitchen existed in the common area. However, during the exit conference, OIG confirmed that no upgrades to the "units" occurred. During the audit, OIG conducted a site visit and observed that Amaranth's clubhouse included a small kitchen (about 600 square feet) to service the residents. However, no support was provided to show that HUD funding was used for the construction of the kitchen or to support fraud, which Prudential alleges.

Comment 6 Prudential's comments state that the proposed OIG finding that Prudential did not underwrite and process a $19.9 million loan in accordance with HUD requirements is wrong. Prudential also stated that the first four of the five contentions that OIG uses to support its incorrect conclusion are based directly on the appraisal and market study that HUD reviewed and approved, which is HUD's responsibility.

However, Prudential, being a MAP-approved lender, failed to perform its roles and responsibility in the underwriting process before HUD's approval of documents, which include conducting a review of third-party reports, such as the market study and appraisal. See comment 1 above. Prudential also provided a certification, which was relied on by HUD, that the loan documents, including the third-party appraisal and market study, were reviewed by Prudential and complied with HUD requirements.

Comment 7 Prudential's comments state that the operating deficit reserves requirement was properly calculated under the MAP Guide, which the audit determined was not. Prudential also stated that OIG makes the contention because it disagrees with the absorption rate concluded by the third-party appraiser, which according to OIG, overstated the absorption rate and, therefore, understated operating reserves.

However, as documented in the audit report, OIG reviewed the absorption rate table included in the market study and appraisal. Most of the properties included in the table were low-income tax credit properties, which were not comparable to Amaranth, as required by the MAP Guide, and would not support the absorption rate estimated by Prudential's appraiser. Prudential certified that the third-party reports, including the market study, were reviewed and in compliance, including all required items, such as a "supported" absorption rate; however, OIG determined that this certification was not correct. In addition to the certification provided by Prudential, the MAP Guide, Revised 2002, paragraph 1-4(C)(5), requires Prudential to conduct a review of the underwriting, including reviewing the appraisal and market study. Prudential's response continues to emphasize HUD's responsibility and approval; however, Prudential had the responsibility to fulfill its obligations under the MAP Guide as well.

Further, Prudential stated that OIG has not and cannot demonstrate that the appraiser's absorption analysis was wrong at the time the appraiser conducted the analysis. However, It is clearly stated in the finding of the report and restated in OIG's evaluation of the auditee comments that OIG used only the information provided in the appraisal and market study, which was used during the time of the underwriting of Amaranth, to conduct its analysis and support its conclusions. Only the data that were available to Prudential and its appraiser at the time of underwriting were used to conduct the audit. OIG stated that an absorption rate of 5 units per month was supported, not 4 as stated in Prudential's comments, which was still higher than the 4.5 supported by the comparable property. Unfortunately, Prudential fails to recognize that a market rate complex is not comparable to a low-income tax credit complex. In addition, Prudential continues to justify using properties more than 45 miles away from Amaranth to support the projected absorption rate. Section 7-14 of the MAP Guide clearly states that the absorption rate must be supported by comparable properties within the market area.

Comment 8 Prudential's comments state that the appraisal report complied with the MAP Guide requirements and that both HUD and the Lender Quality and Monitoring Division report concluded that the appraisal complied with MAP Guide requirements. However, as documented in the audit report, the appraisal did not comply. Prudential also stated that the appraisal was properly supported as required by the MAP Guide and that the site information was appropriate. However, as documented in the audit report, the appraisal did not comply with the requirements and was unsupported with inappropriate site information.

Although the appraisal is a professional opinion, it must be supported and include verifiable information, which Prudential's appraisal did not. The chart in the audit report is supported with factual information in the narrative of the report as well as cited requirements in the footnotes of the report. The land value concluded by OIG is supported with information that was available to Prudential's appraiser at the time the appraisal was conducted. In addition, the hypothetical condition provided by Prudential's appraiser did not, but should have recognized that Amaranth did not have road access and utilities, which would have impacted the conclusions included in the appraisal.

Comment 9 Prudential's comments state that the market study demonstrated a market need and feasibility and that OIG invents requirements, which are not in the MAP Guide. OIG does not agree. The MAP Guide provides specific criteria for the market study in section 7-5. As documented in the audit report, the market study did not support a market need as proposed and included incomparable properties.

Although, some of the comparable properties were constructed in prior years, adjustments were not made to accommodate their superior location, which was also recognized by Prudential's appraiser. In addition, Prudential's appraisal stated that the primary market area for Amaranth included Carrolton, Farmers Branch, and Addison, which included properties comparable to Amaranth. Therefore, the property 45 miles south in Fort Worth was not included in the primary market area, as required by the MAP Guide, and appeared to be an outlier in comparison to the other properties. The MAP Guide, section 7-5, states that the market study must adequately describe the characteristics of the market area. In addition, HUD Handbook 4465.1, paragraph 1-8(F), states that data are used to determine quantitative demand in the community and qualitative demand for the project proposed in the neighborhood selected. The objective of this analysis is to provide information on market trends and predict the prospective absorption capacity of the market.

Comment 10 Prudential's comments state that the project revenue was calculated as required by the MAP Guide and that OIG did not identify any section of the MAP Guide that would support its position. However, as documented in the audit report, the project revenue was not supported and, thus, was overstated. The criteria is referenced in the footnotes of the report, MAP Guide, paragraph 7-6(B), states that the indicated rent estimate will be from the central 60 percent of the rental range of the indicated rents (average). Just as the most appropriate rent comparable must receive more weight, the general health of the rental market must be recognized before relying upon one or two optimistic indicators. Prudential's appraiser failed to take an average estimate from the primary market area as required and as a result, allowed the rental estimates to be overstated.

Comment 11 Prudential's comments state that the MAP Guide does not require verification of real estate listed in personal financial statements. However, as stated above, the audit report stated that Prudential "should" have obtained support for the assets to be prudent in its underwriting practices. Thus, OIG is not concluding that Prudential was required to obtain support but, rather, that it was required to practice due diligence and prudent underwriting practices as defined in the MAP Guide, paragraphs 11-1(C) and 15-3(A)(6).