



Issue Date March 22, 2011

Audit Report Number 2011-PH-1009

TO: Dane M. Narode, Associate General Counsel for Program Enforcement, CACC
Craig T. Clemmensen, Director, Departmental Enforcement Center, CACB
//signed//

FROM: John P. Buck, Regional Inspector General for Audit, Philadelphia Region,
3AGA

SUBJECT: Deutsche Bank Berkshire Mortgage, Inc., Bethesda, MD, Acquired a \$45.6
Million Loan That Was Not Properly Underwritten in Accordance With HUD's
Multifamily Accelerated Processing Program

HIGHLIGHTS

What We Audited and Why

We audited the underwriting of a \$45.6 million mortgage loan that was acquired by Deutsche Bank Berkshire Mortgage, Inc. (the Lender)¹ to rehabilitate Wingate Towers and Garden Apartments. The audit was performed based on a request from the U.S. Department of Housing and Urban Development's (HUD) Office of Multifamily Development. The Federal Housing Administration (FHA)-insured loan went into default in October 2009 and in May 2010, HUD paid a \$44.3 million insurance claim to the Lender. HUD subsequently sold the property in a note sale in September 2010 for \$14.5 million resulting in a loss of \$29.8 million.

¹ On October 21, 2004, the Lender acquired and became responsible for the loan origination activities, personnel, books and records related to this loan from Berkshire Mortgage Finance Limited Partnership (the Underwriter). The personnel the Lender acquired from the Underwriter continued to oversee the Wingate Towers and Garden Apartments project from the commencement of the construction phase through final endorsement of the loan. On February 7, 2005, the Underwriter changed its name to Berkshire Mortgage Finance Limited Partnership Liquidation (BMFLP Liquidation).

The audit objective addressed in this report was to determine whether the \$45.6 million FHA-insured loan acquired by the Lender was underwritten in accordance with HUD requirements.

What We Found

The Lender acquired a \$45.6 million FHA-insured loan that was not underwritten in accordance with HUD requirements. The Underwriter failed to properly assess, as required, the financial wherewithal of the owner and general contractor, or the construction capabilities of the general contractor. The Underwriter also significantly understated the amount of repairs needed to bring the property up to marketable condition. Based on the Underwriter's recommendation, HUD approved the project and the general contractor. The project failed, resulting in a loss of \$29.8 million to the taxpayer.

What We Recommend

We recommend that HUD's Associate General Counsel for Program Enforcement perform a legal review of applicable documents to determine the responsible party that is liable for incorrectly certifying to the integrity of the data or that due diligence was exercised by the underwriting of the loan that resulted in a loss to HUD totaling \$29.8 million which could result in affirmative civil enforcement action of more than \$118 million,² and to pursue remedies under the False Claims Act against the responsible party if it is determined legally sufficient to do so. Additionally, we recommend that the Director, Departmental Enforcement Center, take appropriate administrative action against the responsible party for the material underwriting deficiencies cited in this report.

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

Auditee's Response

We provided a draft report to the Lender on January 14, 2011. We discussed the audit results with the Lender during the audit and at an exit conference on January, 28, 2011. The Lender provided written comments to our draft report on

² We estimated the potential affirmative civil enforcement action of approximately \$118 million by determining the amount of the claim paid times 3 minus the amount of the note sale (\$44,274,712 times 3 minus \$14,499,999 = \$118,324,137).

February 8, 2011.³ It disagreed with the report. The complete text of the Lender's response, along with our evaluation of that response, can be found in appendix B of this report.

³ BMFLP Liquidation was not asked to provide written comments to the draft audit report. Although it technically is an existing entity, BMFLP Liquidation has no employees and is not actively engaged in business.

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BACKGROUND AND OBJECTIVE

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

In August 2002, HUD's Baltimore, MD, Multifamily Program Center (center) received a Section 221(d) (4) substantial rehabilitation mortgage loan application from Berkshire Mortgage Finance Limited Partnership (the Underwriter), a MAP-approved lender, on behalf of Wingate Development, LLC, the owner of Wingate Towers and Garden Apartments. The Wingate Towers and Garden Apartments property is a 717-unit apartment complex built in the mid-1960s on a 21.6 acre site located in southwest Washington, DC. The original appraiser was not approved by HUD. However, the owner obtained another appraiser and resubmitted the application in December 2002. The center issued an initial endorsement for a \$45.6 million mortgage loan on August 22, 2003. The property was also financed with low-income housing tax credits and tax-exempt mortgage revenue bonds financing. The substantial rehabilitation was to be completed in approximately 21 months. The substantial rehabilitation was not completed until 2008.

On October 21, 2004, German American Capital Corporation (GACC) purchased the mortgage banking, brokerage, lending, and servicing business of the Underwriter. After the asset purchase by GACC, the Underwriter's business was continued by a GACC affiliate named Deutsche Bank Berkshire Mortgage, Inc. (the Lender), which took over the Underwriter's offices, files, and employees. On February 7, 2005, the Underwriter changed its name to Berkshire Mortgage Finance Limited Partnership Liquidation (BMFLP Liquidation). BMFLP Liquidation exists for the sole purpose of providing security against losses to GACC. Although it technically is an existing entity, BMFLP Liquidation has no employees and is not actively engaged in business. Since the GACC acquisition, BMFLP Liquidation has not maintained audited financial statements.

On October 1, 2009, 73 months after acquiring the loan and making 7 mortgage payments, the owner defaulted on the loan. Based upon the final settlement statement, the note was assigned to HUD, and HUD recorded the assignment on February 9, 2010. HUD paid \$44.3 million to the Lender for the Wingate Towers and Garden Apartments' insurance settlement and sold the mortgage note for \$14.5 million, a loss of \$29.8 million.

HUD's Office of Multifamily Development Lender Qualification and Monitoring Division completed a review on Wingate Towers and Garden Apartments in October 2008. The purpose of reviewing the potentially troubled project was to determine whether the Lender complied with program requirements. The Division's February 27, 2009, report concluded that the Lender primarily caused the default by not performing an adequate underwriting analysis. The report stated that the Lender failed to properly scrutinize the experience and credit worthiness of the owner and general contractor, and failed to ensure the scope of work was adequate. The report also stated that the Lender permitted the use of unauthorized valuation techniques which inflated the mortgage amount. The division's determination was that the misrepresentation by the Lender's underwriter was the primary reason for the default and assignment of the loan.

The audit objective addressed in this report was to determine whether the \$45.6 million FHA-insured loan acquired by the Lender was underwritten in accordance with HUD requirements.

RESULTS OF AUDIT

Finding: The Lender Acquired a \$45.6 Million FHA-Insured Loan That Did Not Meet HUD's Underwriting Requirements

The Lender acquired a loan in which the Underwriter did not perform a complete financial analysis of the owner or general contractors as required and did not accurately evaluate the experience and qualifications of the sponsor and general contractor. The Underwriter also failed to ensure that the scope of work included all needed repairs to bring the property to a marketable condition. The Underwriter did not practice the required due diligence during its analyses. Based on the Underwriter's recommendation, HUD insured a mortgage loan that was not feasible nor completed within the established timeframe. The project failed and resulted in a loss to HUD of \$29.8 million.

The Underwriter Did Not Perform a Complete Financial Analysis of the Owner or the General Contractors

A key component of the underwriting process is to assess the mortgagor's ability to manage the development, construction, completion, and successful lease-up of the property. The Underwriter did not perform a complete financial analysis of the owner or the general contractor of the project. Specifically, the Underwriter did not (1) perform a full credit investigation of the sponsor and the principals of the project and (2) obtain complete financial statements from the general contractors to accurately determine its working capital position.

The Underwriter did not perform a full credit investigation of the sponsor and the principals of the project. The Underwriter failed to obtain a credit report for the sponsor of the property⁴ because the business entity had been formed 10 months prior to the insurance application. Thus, the business entity had no business concerns. The Underwriter also stated that five of the principals' business entities were newly formed thus commercial credit reports could not be obtained. Since the sponsor and affiliated principals' companies were newly formed and had no operating history, the Underwriter was required to obtain individual credit reports of those parties.

The Underwriter also did not verify the trade references for the sponsor and the principals. The Underwriter's file did not include complete records verifying that bank and trade references were performed and the Underwriter did not ensure that

⁴ MAP Guidebook, chapter 8, section 8.3.E.3

all principals completed the necessary forms to disclose account numbers, present balances, and terms of the accounts. The MAP Guidebook required that bank and trade references be verified to confirm financial stability.⁵

The Underwriter did not obtain complete financial statements and supporting schedules of the principals and its general contractors.⁶ The unaudited financial statements of the principals did not include the supporting schedules for accounts receivable, notes receivable, pledged assets, accounts payable and notes payable as required. The Underwriter also failed to obtain various financial statements including balance sheets, income and expense statements, and statements showing the business' financial position, fund balances, notes and other relevant financial statements. According to the incomplete financial statements that were obtained, two of the principals had suffered net losses between \$34,450 and \$138,718 over a 2-year period. The MAP Guidebook required the Underwriter to obtain and review the supporting financial statements and schedules for the past 3 years.⁷

The Underwriter did not accurately determine the general contractors' joint venture⁸ working capital position. Working capital is the excess of current assets over current liabilities. The MAP Guidebook required the Underwriter to make a working capital determination. In order to determine working capital, the Underwriter was required to obtain financial statements showing the contractors' current assets and liabilities as of the same cut-off date. Although the contractors submitted balance sheets, the cut-off dates for the financial statements were different. One set of financial statements was dated March 3, 2003, and the other was dated April 30, 2003. The Underwriter should have required both parties to submit balance sheets with the same cutoff dates to be able to determine a more accurate working capital position.

The MAP Guidebook required the Underwriter to perform a comparative analysis of the information obtained from the credit reports and financial statements. This process would have allowed the Underwriter to obtain a complete financial picture of all parties involved in the Wingate Towers and Garden Apartments loan. Without obtaining the appropriate credit reports and complete financial statements, the Underwriter did not make an accurate determination as to whether the borrowers or the general contractors had the financial wherewithal to develop, build and complete the project. The Underwriter certified that the loan was an acceptable risk to the HUD multifamily insurance program when it had not practiced due diligence in evaluating the credit of the borrowers.

⁵ MAP Guidebook, chapter 8, section 8.3.H

⁶ MAP Guidebook, chapter 8, section 8.4

⁷ MAP Guidebook, chapter 8, section 8.4.B.2.a

⁸ The MAP Guidebook, chapter 8, section 8.4.C.12.d, permits a joint venture if a general contractor does not have an acceptable working capital position. The joint venture may be established with a financially stronger general contractor provided these firms' combined working capital equals at least 5 percent of all construction contract amounts. However, prior to initial endorsement the joint venture terminated, leaving a less experienced contractor to perform the rehabilitation.

The Underwriter Did Not Accurately Evaluate the Sponsor's and General Contractor's Experience

The Underwriter did not accurately evaluate the sponsor's and general contractor's experience as required. The MAP Guidebook required that the Underwriter ensure that the owner and general contractor have sufficient experience in developing, owning or building similar multifamily properties.⁹ The Underwriter was required to carefully evaluate whether the owner's or general contractor's past experience included work performed on similar projects, the length of time served on each project, and past roles in the multifamily business. The resume provided for the sponsor indicated limited management experience with multifamily-insured projects and no ownership experience. The sponsor's previous experience instead dealt with real estate lending and real estate development. The resume did not reflect experience with the day-to-day management of any multimillion dollar multifamily projects. As a result, the managing general partner of the ownership entity could not resolve construction issues that occurred during the rehabilitation, nor could they contribute financially. In October 2007, the sponsor and the other general partner agreed that they would withdraw from the ownership and terminate any future involvement.

The resume provided by the general contractor did not provide complete information indicating that they had sufficient experience with rehabilitating a multifamily-insured project. The general contractor's resume failed to show the size of the projects completed and the role of the general contractor related to each project. Based upon the project experience list provided by the general contractor, the general contractor had worked on 101 projects. However, of the 101 projects, only 1 project had substantial rehabilitation costs of more than \$26 million. The general contractor was ultimately removed in May 2005 due to significant issues related to the work performed and was replaced by the bonding company.

The MAP Guidebook required the Underwriter to evaluate the resumes of the principals. Specifically, the Underwriter was to evaluate the sponsor's and general contractor's experience in developing, owning or building similar multifamily properties. The Underwriter was also to evaluate the type and size of previous projects and the past roles in the multifamily business. The Underwriter incorrectly asserted that both parties had adequate experience. Ultimately, due to lack of funds, poor management, and poor workmanship during the rehabilitation of the project, both the sponsor and the general contractor were removed from the project before the project was completed. A project that was to be completed within 2 years was completed within 5 years. Although the Underwriter had not

⁹ MAP Guidebook, chapter 8, section 8.3.J

adequately evaluated the owner's and general contractor's resumes, it recommended the loan for insurance. Unfortunately, HUD relied on the Underwriter's recommendation and the loan was insured.

The Underwriter Failed To Ensure That the Scope of Work Included All Needed Repairs

For a substantial rehabilitation project, the scope of work must provide for the replacement of all doors, windows, roofs, cabinets, and mechanical/conveyance systems. A detailed work writeup must describe in narrative form the required rehabilitation. Although a scope of work was prepared, the Underwriter incorrectly determined the scope of work that would bring the property up to a marketable condition.

A third party cost review estimated that the project would incur construction costs of more than \$26 million. However, the Underwriter failed to ensure that the estimated costs included costs for asbestos removal and other needed repairs. The architect's survey report identified asbestos-containing materials throughout the property and provided recommendations for asbestos removal. The Underwriter ensured HUD that the asbestos would be removed in accordance with all local and Federal regulations. However, the general contractor was not aware of the additional costs associated with the removal. Thus, during the rehabilitation of the project, the general contractor filed a demand for arbitration claiming that the asbestos removal was outside of the scope of work. The additional cost of the asbestos removal was \$680,000.

The project also experienced numerous changes to the original scope of work. Specifically, the general contractor submitted 99 change orders throughout the project. The change orders included requests for extensions to complete the project, and for replacing additional drywall, flooring and doors. Overall, the change orders included the following increased costs:

Work item	Original cost estimate	Change order amount	Total cost	Percent increase
Asbestos removal	\$0	\$680,000	\$680,000	not applicable
Drywall	\$467,272	\$360,500	\$ 827,772	77
Floors	\$305,244	\$302,318	\$607,562	99
Doors	\$1,028,282	\$260,518	\$1,288,800	25

At completion of the project in 2008, the Wingate Towers and Garden Apartments loan construction costs totaled more than \$70 million, an increase of \$44 million from the original \$26 million. Although the project had rehabilitation costs totaling more than \$70 million, the property never reached its projected 95 percent

occupancy level, revenues estimated during underwriting were not realized, and ultimately the project failed. HUD paid a \$44.3 million claim on the property.

The Underwriter's Certification Was Incorrect

The Underwriter incorrectly certified that due diligence was used in the underwriting of the Wingate Towers and Garden Apartments loan. Specifically, the Underwriter certified that the MAP application for FHA-insured multifamily loans was prepared and reviewed in accordance with HUD requirements although it had not properly analyzed the credit history of the sponsor and principals, accurately evaluated the sponsor's and general contractor's experience, and incorrectly determined the scope of work to bring the property up to marketable condition as required by the MAP Guidebook.

Conclusion

HUD placed confidence in the Underwriter's integrity and competence but it failed to follow and implement the MAP Guidebook and other relevant guidance during the underwriting of the loan. The Underwriter did not properly analyze the credit history of the sponsor and principals, accurately evaluate the sponsor's and general contractor's experience, and incorrectly determined the scope of work to bring the property up to marketable condition as required by the MAP Guidebook. As a result, HUD approved a loan with significant financial and business risk. The owner defaulted on the loan resulting in a loss to HUD of \$29.8 million.

Recommendations

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

- 1A. Perform a legal review of applicable documents to determine the responsible party that is liable for incorrectly certifying to the integrity of the data or that due diligence was exercised by the underwriting of the loan that resulted in a loss to HUD totaling \$29.8 million.
- 1B. If legally sufficient, pursue remedies under the False Claims Act against the responsible party if they are found liable for incorrectly certifying to the integrity of the data or that due diligence was exercised by the underwriting of the loan that resulted in a loss to HUD totaling \$29,774,713 which could result in affirmative civil enforcement action of more than \$118 million.

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

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

SCOPE AND METHODOLOGY

We conducted the audit from June to December 2010 at the Lender's offices located at 4550 Montgomery Avenue, Bethesda, MD, HUD's Office of Multifamily Development in Washington, DC, and our offices located in Richmond, VA. The audit covered the period December 2002 through December 2009.

To accomplish our objective, we reviewed

- Relevant background information including HUD's monitoring reports and project reviews;
- HUD's MAP Guidebook and other requirements;
- The Lender's audited financial statements; and
- The underwriting loan file for Wingate Towers and Garden Apartments which included the pre- and firm application, property appraisal report, construction contract, certifications, and other financial information used during the underwriting process.

We conducted interviews with the Lender's acquired staff, including the originating underwriter, construction specialist and officials from HUD's Office of Multifamily Development. We selected and reviewed the Underwriter's loan file for the Wingate Towers and Garden Apartments FHA-insured multifamily loan.

We determined the loss to the FHA fund to be \$29.8 million (the amount of the claim paid \$44,274,712 minus the amount of the note sale \$14,499,999 = \$29,774,713).

We estimated the potential affirmative civil enforcement action of approximately \$118 million by determining the amount of the claim paid times 3 minus the amount of the note sale (\$44,274,712 times 3 minus \$14,499,999 = \$118,324,137).

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

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Policies, procedures and other management controls implemented to ensure that the Lender administered the Wingate Towers and Garden Apartments loan 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 a whole. Accordingly, we do not express an opinion on the effectiveness of the Lender's internal control.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS

Recommendation number	Unreasonable or unnecessary 1/
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1B	\$29,774,713
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
- 1/ Unreasonable or unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/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 costs to be the loss to the FHA fund of \$29,774,713 (the amount of the claim paid \$44,274,712 minus the amount of the note sale \$14,499,999).

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

<p>Deutsche Bank Berkshire Mortgage</p>	<p>Deutsche Bank </p>
	<p>Deutsche Bank Berkshire Mortgage, Inc. One Beacon Street, 14th Floor Boston, MA 02108</p>
	<p>Tel 1-617-722-5000 Fax 1-617-722-5090</p>
<p><u>VIA E-MAIL AND FEDERAL EXPRESS DELIVERY</u></p>	
<p>February 8, 2011</p>	
<p>U.S. Department of Housing and Urban Development Office of Inspector General Attn: Mr. John Buck Regional Inspector General for Audit Wanamaker Building 100 Penn Square East, Suite 10205 Philadelphia, PA 19107-3380</p>	
<p>Re: <u>Response to OIG Audit of FHA Project No. 000-35415</u></p>	
<p>Dear Mr. Buck:</p>	
<p>Deutsche Bank Berkshire Mortgage, Inc. ("DBBM"), is pleased to provide the Office of the Inspector General with DBBM's response to the Draft Audit Report in connection with the above-referenced audit. For your convenience, we have prepared an executive summary which should accompany and be considered part of the response.</p>	
<p>Please do not hesitate to contact me should you have any questions regarding this submission.</p>	
<p>Sincerely,  Steven B. Wendel</p>	
<p>Enclosure</p>	

Executive Summary DBBM Response to Draft OIG Audit Re Wingate

Comment 1

Background of DBBM

- Deutsche Bank Berkshire Mortgage, Inc. and its wholly owned subsidiary DB Mortgage Services LLC (collectively “DBBM”) has an exemplary record as an FHA originator and servicer. Since DBBM’s license became effective on October 21, 2004, DBBM has closed 118 FHA loans totaling \$1.01 billion. Despite the large volume of mortgage loans that DBBM originates, only 1 has defaulted. Both by loan count and by unpaid principal balance, DBBM’s default rate is less than 1.0%. All of DBBM’s FHA loans are current as of January 26, 2011.
- DBBM is very troubled by the analyses, findings and recommendations contained in the draft OIG report (“Report”).

Comment 2

DBBM is the Wrong Entity to Pursue

- DBBM’s response is primarily based on review of Berkshire Mortgage Finance’s (“BMF”) files in DBBM’s possession. BMF was a separately licensed FHA-approved mortgagee unrelated to DBBM from which DBBM acquired the origination and servicing platforms and servicing rights attributable to BMF’s mortgage origination and servicing business (but not certain excluded liabilities including liabilities resulting from actions taken prior to the asset sale) in 2004, including the servicing rights on the Wingate Towers and Garden Apartment (“Wingate”) loan on which BMF had been the original lender. DBBM therefore cannot vouch for the accuracy or completeness of files nor actions taken by principals of BMF. While today BMF has changed its name, it still exists in Massachusetts as a limited partnership in good standing. Given the circumstances, we urge HUD to provide the Report to BMF and afford them an opportunity to respond before the Report is finalized. DBBM is not authorized to make statements on BMF’s behalf, and nothing herein should be construed as an admission of liability on the part of BMF.
- OIG found shortcomings in underwriting and certification in connection with initial endorsement of Wingate. All of these actions were undertaken entirely by BMF prior to the legal existence of DBBM. The Report in no way found any fault with DBBM as to any activities it performed after the acquisition of the initially endorsed Wingate loan.
- DBBM believes it is totally inappropriate and legally unsupportable to pursue sanctions against DBBM rather than against BMF if OIG decides to finalize its Report with such recommendations.
- The Report fails to state any legal basis that justifies the transfer of legal exposure for BMF’s actions from BMF to DBBM. The Report is particularly troubling in that it proposes possible action under the largely punitive False Claims Act. The Report makes no findings of actual knowledge, deliberate ignorance, or reckless disregard of the truth or falsity of the information on the part of DBBM, which would be required to establish liability under such Act. Such an action is therefore totally unsustainable since DBBM was not aware of and had no reason to believe that such allegedly inappropriate activity had occurred.

Comment 2

Comment 2

Comment 2

Comment 3

- DBBM believes that a potentially significant report prepared by FHA of BMF's underwriting performance may exist and, if it does, has not been evaluated in any way by the OIG. While DBBM has no written record in the files it obtained from BMF of such a report, it has learned from former BMF employees that FHA may have performed an audit of BMF's underwriting performance shortly after Wingate was initially endorsed. During its exit interview with the OIG and HUD's multi-family staff, DBBM questioned attendees about such a report. Nobody was aware of its existence but it was agreed that the OIG/FHA would seek to determine if such a report had actually been prepared and, if so, share it with DBBM. Until a final determination is made as to the existence and contents of this report, DBBM believes it is premature to proceed beyond the initial draft report. If such a report exists following DBBM's submission of its response to the draft audit, DBBM requests the opportunity to evaluate the report and prepare a supplemental response before issuance of the final report to DBBM. DBBM will be submitting a request under the Freedom of Information Act to obtain a copy of this report.

Comment 4Unanticipated Consequences of Imposing Sanctions against DBBM

- Imposing sanctions against DBBM will likely cause significant turmoil in the multi-family mortgage loan and servicing acquisition marketplace. It could materially decrease the value of multi-family servicing rights and potentially could result in a large reduction in the demand for HUD multi-family lending programs. This is likely to be particularly true in cases similar to Wingate in which, as DBBM understands it, FHA was intimately involved in the underwriting of the loan. In fact, DBBM believes that HUD strongly recommended that the project be undertaken by BMF and has submitted documentation to support this position to HUD at the exit conference. While it is understood that HUD's recommendation does not absolve BMF of its underwriting obligations, DBBM believes that HUD's recommendation is a factor that should be considered by the OIG.

Comment 5No Linkage between Alleged BMF Underwriting Deficiencies and Loss Suffered by FHA

- Whether the Report's findings regarding alleged underwriting deficiencies in BMF's underwriting processes are correct or not (and DBBM believes based on its review of BMF's files that such findings are significantly flawed), they are not the real cause of FHA's loss on Wingate. BMF's files appear to demonstrate that BMF structured the process with extensive additional safeguards to ensure successful project completion. The underwriting deficiencies, even if correct, pale in comparison to the extra efforts taken by BMF, particularly given all the unanticipated developments in the marketplace where the project was located.

Comment 5DBBM's Response to Alleged Underwriting Deficiencies

- The DBBM response to the Report contains an item by item evaluation in response to each of the alleged underwriting deficiencies. The evaluations reflect DBBM's interpretation of materials contained in BMF's files. While not all of the findings are refuted, DBBM believes that it has effectively addressed many of the more significant alleged deficiencies and, when taken in conjunction with the additional general underwriting protections required by BMF, has addressed the core concerns that the OIG may have.

Deutsche Bank Berkshire Mortgage



Deutsche Bank Berkshire Mortgage, Inc.
One Beacon Street, 14th Floor
Boston, MA 02108

Tel 1-617-722-5000

February 8, 2011

BY EMAIL AND FEDERAL EXPRESS

U.S. Department of Housing and Urban Development
Office of Inspector General
Attn: Mr. John Buck
Regional Inspector General for Audit
Wanamaker Building
100 Penn Square East, Suite 10205
Philadelphia, PA 19107-3380

Re: OIG Audit of FHA Project No. 000-35415

Dear Mr. Buck:

Deutsche Bank Berkshire Mortgage, Inc. and its wholly owned subsidiary DB Mortgage Services LLC (collectively "DBBM" or the "Company") appreciate the opportunity to respond to the draft audit report (the "Draft Report") of the U.S. Department of Housing and Urban Development ("HUD") Office of Inspector General ("OIG") dated January 14, 2011, and to follow up on matters discussed relating thereto at the exit conference with the OIG and multifamily personnel on January 28, 2011 (the "Exit Conference"), with respect to the underwriting of a \$45.6 million Federal Housing Administration ("FHA") insured loan for Wingate Towers and Garden Apartments.

Overview

As you no doubt appreciate, DBBM is very concerned with the OIG's Draft Report. In particular, we believe that (i) the Draft Report is based, in part, on factual inaccuracies; (ii) the alleged underwriting deficiencies are not the real cause of the losses incurred by HUD seven years after the initial endorsement; and (iii) most important, the findings and recommendations proposing corrective action are addressed to the wrong legal entity – DBBM – rather than the entity which underwrote and certified as to the loan – Berkshire Mortgage Finance Limited Partnership (HUD License No. 70970-000-9) ("BMF").

In this respect, we note that the actions at issue in the Draft Report were all taken by BMF, an entity unrelated to DBBM, which operated under a different license and has different ownership and principals. In 2003, BMF originated and underwrote the subject Wingate Towers loan, with an initial endorsement dated August 22, 2003. At that time, DBBM did not even exist. On

Comment 5

Comment 2

John Buck
Regional Inspector General for Audit

February 8, 2011

Comment 1

October 21, 2004, DBBM was incorporated and, as set forth below, it has since had an exceptional record in the industry. Thereafter, DBBM, pursuant to an Asset Purchase Agreement dated August 12, 2004 (as amended, the "APA") purchased the origination and servicing platforms of BMF and servicing rights attributable to the mortgage origination and servicing business of BMF. Certain assets and liabilities, however, were excluded from the purchase. Among the Excluded Liabilities in the APA were those related to all activities undertaken by BMF prior to the closing date of the APA, such as those at issue here with respect to the subject loan's underwriting.

Comment 2

Comment 2

Although the findings in the Draft Report all relate to conduct by BMF, to our knowledge HUD has not shared the Draft Report with BMF or afforded it the opportunity to comment. Accordingly, notwithstanding the fact that BMF is in a better position to comment on its own conduct, we have undertaken a review of files obtained from BMF in respect of the factual allegations in the Draft Report. Our factual conclusions are primarily based on the review of those files. However, because the files predate DBBM's purchase of the loan, we are unable to vouch for the accuracy of those files, the actions or omissions by the principals or participants involved in the transaction, or the impact of those actions or omissions on the transaction.

Comment 2

Accordingly, and for the reasons outlined below, we respectfully submit that there is no reason for you to recommend that HUD pursue remedies under the False Claims Act and/or administrative actions against DBBM.

Comment 1

DBBM's Exemplary Record in the Industry

We are proud of our exemplary record as an FHA originator and servicer, and we are confident that it is among the best in the industry. DBBM is a recognized industry leader in multifamily financing for Fannie Mae, Freddie Mac, and FHA loans. In 2009, DBBM closed approximately \$4.6 billion in multifamily mortgage originations. Our servicing portfolio is comprised of over 2,200 loans in 45 states and the District of Columbia totaling nearly \$28.5 billion. We have received numerous awards for excellence in underwriting and operations. In two of the past four years (2007, 2009), DBBM received the "Fannie Mae Excellence in Underwriting" award, which goes to the DUS Lender judged to have the best Underwriting practices each year.

Comment 1

Since October 21, 2004, when DBBM became incorporated and its FHA multifamily mortgagee approval was issued, DBBM has closed 118 FHA loans totaling \$1.01 billion. We are proud of the fact that, despite the large volume of mortgage loans that DBBM originates, only one FHA-insured loan originated by DBBM, with a total loan unpaid principal balance of \$7.06 million, has resulted in a default. Both by loan count and by unpaid principal balance, DBBM's default rate is less than 1.0%. All of DBBM's FHA loans are current as of January 26, 2011.

Comment 2

DBBM is not the Proper Party

As noted above, DBBM is deeply concerned that the Draft Report makes findings of inadequate underwriting due diligence by DBBM when, in fact, DBBM was not the underwriter and did not yet exist at the time of the underwriting. The Draft Report offers no factual basis for its allegations against DBBM. It is indisputable that BMF, not DBBM, underwrote the loan in

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Comment 2

question. When this issue was raised in the Exit Conference, no explanation was provided for seeking to establish liability against DBBM. The Draft Report likewise offers no legal basis to transfer potential liability from BMF to DBBM or for HUD to take punitive or administrative action against DBBM for alleged errors committed by BMF. After the underwriting of the loan, the initial endorsement of the loan was completed by BMF. Subsequently, DBBM was formed, was approved as a HUD/FHA non-supervised mortgagee, and acquired certain assets from BMF, including servicing rights attributable to the Wingate loan. While the APA provided that DBBM would acquire certain assets, it also required BMF to retain certain liabilities. BMF remains responsible for those excluded liabilities, including any liabilities that may result from actions taken prior to the asset sale – such as those connected to its origination and underwriting of the Wingate Towers loan. BMF has changed its name but still exists today as a limited partnership in good standing in the Commonwealth of Massachusetts. We would strongly recommend that BMF be provided a copy of the Draft Report and afforded an opportunity to respond before the Draft Report is finalized.^{*}

Comment 2

Even had the Draft Report contained factual or legal findings supporting DBBM's responsibility for underwriting the loan in question, such findings still would not support a recommendation to seek redress against DBBM under the False Claims Act. The False Claims Act's treble damages provision is designed to punish knowing offenders. The Draft Report contains no findings suggesting that DBBM and its principals are the alleged offenders, or even that they had knowledge of the alleged underwriting deficiencies by BMF. To the contrary, when DBBM entered into negotiations with BMF to acquire certain of its assets, DBBM performed a standard and appropriate level of due diligence of the overall loan portfolio which did not uncover the alleged deficiencies cited in the Draft Report. Without any findings in the Draft Report indicating that DBBM had actual knowledge, deliberately ignored, or recklessly disregarded the alleged underwriting deficiencies, we believe it is inappropriate to recommend potentially pursuing action against DBBM under the False Claims Act.[†]

Industry-Wide Effects of this Action by HUD

We are also concerned that the impact of this action on the industry as a whole has not been fully understood or appreciated. We believe that HUD's release of the Draft Report will have a widespread chilling effect on transactions similar to the BMF-DBBM transaction, as well as on the sale of multifamily origination and servicing platforms and servicing rights, which we do not believe is HUD's intent. By recommending the imposition of liability on a buyer (DBBM) of servicing rights originated by a seller (BMF) of such rights, including both financial liability and

Comment 2

^{*} We note that, as of the date of this response, BMF has not been provided a copy of the Draft Report or an opportunity to respond to it. Nothing herein should be viewed as limiting or restricting BMF's ability to offer a response, nor are we authorized to make statements on their behalf, and nothing herein should be construed as an admission of liability on the part of BMF.

[†] While this response does not advance legal arguments in support of DBBM's position, we note that in order to establish liability under the False Claims Act, it is necessary to show that the party being pursued had actual knowledge of the information, acted in deliberate ignorance of the truth or falsity of the information, or acted in reckless disregard to the truth or falsity of the information.

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regulatory exposure, HUD is inserting a massive new risk into the process of selling these assets. Buyers of FHA servicing rights have not historically assumed the risk of any possible sanctions due to alleged underwriting deficiencies by sellers; nor will they have the ability or financial motivation to perform the extraordinary levels of due diligence necessary to fully assess the potential liabilities implied by the OIG’s recommendations in the Draft Report. Even if the market recovers from the damage we believe will occur and begins to function again in the future, market pricing will be materially reduced due to Buyers’ need for protection against future risks of the type discussed herein. This will materially decrease the perceived market value of FHA multifamily lending and servicing platforms, potentially leading to a large reduction in demand for FHA multifamily lending programs.

Comment 4

With respect to the Wingate Towers loan, it is also noteworthy that HUD was directly and actively involved in each step of the origination and loan approval process. While this involvement does not absolve BMF of its obligations as underwriter, it does present a larger issue for FHA and HUD. In many, if not most, instances of FHA multifamily lending, the originating lender discusses potential lending programs with local HUD staff, usually in great detail. In the case of this loan, we have reason to believe that the local HUD office both recommended this project to BMF and was intimately involved in the loan’s underwriting. Should the actions contemplated in the Draft Report be pursued, lenders will become far more reluctant to consider difficult or challenged projects even when such projects are encouraged by the local HUD office in an effort to uplift the community. Again, this could have a chilling effect on HUD’s goals of providing capital to the affordable housing segment of the multifamily market because, as discussed below, these transactions are among the most complex to understand, underwrite, and structure.

Background to the Wingate Towers Transaction

The Wingate Towers transaction was a 221(d)(4) substantial rehabilitation project that utilized Low-Income Housing tax credits (“LIHTC”) as a significant source of equity. As is typical with LIHTC sub-rehab transactions, the Wingate Towers transaction involved a more complex structure and array of participants and responsibilities than a non-LIHTC transaction. Typical of this type of transaction, BMF’s files indicate the roles and responsibilities were as follows:

- General Partner (“GP”): responsible for site control, tenant relationships, obtains tax credit allocation.
- General Contractors (“GC”): responsible for construction/sub-rehab.
- Tax Credit Syndicator: financial partner, generally funds 100% of the equity capital, provides affordable housing management expertise, construction/rehab and property management expertise, and provides additional capital for cost overruns as a result of LIHTC fund structures and potential recapture exposure.

Comment 5

Our review of BMF’s files indicates that BMF structured the Wingate Towers transaction with additional safeguards to better ensure project completion, as follows:

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- PFG Holdings Corporation (“PFG”), a billion-dollar organization with vast LIHTC and multifamily expertise, was inserted as co-GP with decision-making authority for all decisions and mandatory approval for major decisions, in order to utilize their experience with similar projects.
- The Hartford Insurance Company (“Hartford”), one of the largest and highest-rated U.S. insurance companies, underwrote a surety bond for construction completion for the project. As such, they underwrote and agreed to backstop the GCs.

Comment 5

Between 2005 and 2009, these two entities expended substantial resources, including almost \$25 million of additional equity capital, in order to complete the rehabilitation and reach Final Endorsement. This additional equity contribution is greater than fifty percent of the original loan amount. The percentage of additional equity relative to the loan balance is virtually unprecedented in the FHA-insured multifamily lending industry, even in circumstances of a tax credit transaction. This undertaking by PFG further supports BMF’s structuring of the transaction and the soundness of its underwriting process.

Actual Causes of the Loan’s Eventual Default

Comment 5

The Draft Report cites actions taken and not taken by BMF as alleged deficiencies in BMF’s underwriting process. In other circumstances, these alleged deficiencies may have impacted completion of the project. However, BMF’s structural safeguards ensured that the transaction reached Final Endorsement, albeit at great cost to PFG and Hartford. Typical of LIHTC sub-rehab transactions, the financial partner (PFG in this instance) was counted upon by the lenders and FHA to ensure the transaction is completed, which is exactly what occurred in this case. In fact, HUD’s loss was caused by circumstances completely unrelated to the alleged deficiencies. The principal cause of this loan’s default was the unforeseen deterioration of the sub-market and its impact on the Wingate property. The file indicates that BMF’s analysis took into account and assumed an intended major revitalization effort for the area. There was a commitment by the city of Washington, DC to spend \$847 million to redevelop the Anacostia area; however, a significant portion of such funding was not provided in the time frame that was anticipated. Unabated and increasing crime in the area and at the property escalated both construction costs and expenses once the property was completed.

Comment 5

The financial impact at the property, including costs for increased security, maintenance and repairs, general and administrative expenses and payroll expenses all contributed to an increase in operating costs of \$4,000 per unit, or approximately \$3 million annually, by 2009 compared to the projected expense levels included in the original underwriting. As the HUD LQMD Report No. 2008BAL03 dated January 6, 2009 notes – “These unforeseen issues could not have been foreseen by any market analyst, appraiser or underwriter.”

Possible Post-Initial Endorsement Audit of Wingate By FHA

Comment 3

During the Exit Conference, DBBM raised the issue that a potentially significant report prepared by FHA of BMF’s underwriting performance may exist and, if it does, it has not been evaluated in any way by the OIG. While DBBM has no written record in the files it obtained from BMF of

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such a report, it has learned from former BMF employees that the FHA may have performed an audit of BMF's underwriting performance shortly after the Wingate loan was initially endorsed. A request was made by DBBM at the Exit Conference that the OIG and HUD investigate and determine if such a report exists. Attendees at the Exit Conference agreed that the report would be provided to DBBM if it is found. To date, there has been no indication from HUD or the OIG that the report has been found. We will be submitting a request under the Freedom of Information Act to obtain a copy of this prior audit because we believe it is critical to a full understanding of the subject transaction. If/when it is found, we hereby request an opportunity to submit a supplemental response based on its findings. Until such time as a final determination is made as to the existence and contents of this report, DBBM believes it is premature to proceed beyond the initial draft report.

Fact-Specific Responses to the Draft Audit Findings

Comment 5

We wish to respond directly to each item of the Draft Report's assertions and underscore certain factual inaccuracies upon which the Draft Report's conclusions appear to be based. Please note that the following responses are predominantly based on files obtained from BMF that predate DBBM's purchase of the loan. DBBM cannot vouch for the accuracy of such files, the actions taken by the principals or participants in the transaction, or the impact of those actions on the transaction. In addition, no statements herein have been authorized by BMF and should not be construed as an admission on the part of BMF; these statements represent our interpretation of the materials contained in the files. We reiterate our request that a copy of the Draft Report be provided to BMF.

The Draft Report's sole Finding is, "The Lender Did Not Ensure That a \$45.6 Million FHA-Insured Loan Met HUD Requirements." In support of this Finding, the auditors raise the following issues, to which we now respond:

1. "The lender did not perform a complete financial analysis of the owner or the general contractor." In support of this statement, the following assertions are made:

OIG ASSERTION:

- o The lender did not perform a full credit investigation of the sponsor and principals of the project. Specifically, the lender did not obtain individual credit reports in lieu of credit reports for the sponsor of the property and five of the principals' business entities which were newly formed.

RESPONSE:

- o Credit reports were pulled on all entities; although reports on the newly formed entities provided no information. Copies of said reports are located in BMF's files.
- o A credit report was not pulled by BMF on Emmanuel Ogundipe as he was in the 4th tier of ownership and the financial strength was provided by the tax credit investor that was owned through PFG.
- o The financial strength and focus of the mortgage credit was PFG, which was formed in February 2001, and acquired by GMAC Holdings Corporation during 2001.

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Comment 6

- i. BMF received an audited 2001 statement from PFG and relied on GMAC's compiled and audited 2002 statement that reflected liquidity in excess of \$12 million and a net worth in excess of \$1.1 billion.
- ii. Capmark Financial Group ("Capmark") acquired GMAC's interests on March 23, 2006. Capmark continued to fund \$10+ million in tax credit equity and provided an additional \$24.7 million to cover property costs, additional repairs resulting from tenant damage, and mortgage payments until Capmark filed for bankruptcy on October 25, 2009.

OIG ASSERTION:

- o The lender did not verify the trade references for the sponsor and the principals. The lender's file did not include complete records verifying that bank and trade references were performed, and the lender did not ensure that principals completed the necessary forms disclosing account numbers, balances and terms of the accounts.

RESPONSE:

- o Chapter 8, Section 8.3 B.4 of the MAP Guide does not specify how many trade references are required; however, the MAP Guide does require that a verification of deposit be received for each bank reference listed.
- o BMF followed up on the trade references listed on the respective HUD-92013 Supp and noted in their write-up how many trade references were obtained and the results of said references.
- o BMF received a verification of deposit for all bank references listed for both the principals and GC.

Comment 7

OIG ASSERTION:

- o The lender did not obtain complete financial statements and supporting schedules from the principals and general contractors. The financial statements that the lender's underwriter reviewed were unaudited statements that did not include supporting schedules. The lender's underwriter also did not obtain various other financial statements.

RESPONSE:

- o PFG: BMF received an audited financial statement for PFG for 2001 and, given their acquisition by GMAC in 2001, relied on the audited 2002 statement for GMAC. Therefore, BMF did not rely on the 2002 financial statement of PFG. GMAC's compiled and audited 2002 statement reflected liquidity in excess of \$12 million and a net worth in excess of \$1.1 billion.
- o D.M. Jones Construction, Inc.: BMF received 1999 – 2001 audited statements. The 2002 statement was certified but not audited and schedules were not received. The March 2003 statement was certified and did not include schedules.
- o AVA Construction Services – BMF received 1998 – 2000 audited statement. The 2001, 2002 and March 2003 statements were certified with no supporting schedules.
- o DM Jones and AVA Construction's financial statements were received by the bonding company, Hartford, and approved for the performance bond. Hartford is considered to be an industry leader and among the most reputable and thorough insurance companies in the market. Involving Hartford in the transaction speaks to BMF's desire to ensure adequate safeguards for the loan. Thus, any failure to receive audited financial statements was not the cause of the loss.

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- As noted in the LQMD finding in the report dated January 6, 2009, AVA Construction transferred their interest back to DM Jones without providing HUD, the Borrower, or BMF with the notice required under the loan documents. Therefore, BMF and the other parties had no opportunity for due diligence on the reconstituted entity.
 - If timely notice had been provided to BMF regarding this transfer, BMF would have been obligated to immediately notify HUD. Following such notification, in accordance with HUD requirements, the closing would have been postponed until a suitable replacement had been identified by the borrower, underwritten by BMF, and approved by HUD. Had this occurred, many of the problems with the general contractor might have been avoided. When notice was provided in 2005, Hartford replaced the general contractor.

OIG ASSERTION:

- The lender did not accurately determine the general contractor's joint venture working capital position because the balance sheets provided by the contractors had different cut-off dates.

RESPONSE:

- Chapter 8, Section 8.4 C.1 of the MAP Guide does not require cut-off dates on financial statements to be the same. The requirement is for statements to be no more than three months old when Form HUD-92013 is submitted.
- DM Jones Construction's statement was dated March, 2003 and AVA Construction's statement was dated April, 2003. The Firm Application was submitted on May 22, 2003; therefore, the respective statements were dated within the required 90 day period.
- Chapter 8, Section 8.4 (12) of the MAP Guide requires that the GC meet a 5% working capital requirement. Section 12 (d) states that a joint venture may be established provided the firms' combined working capital equals at least 5%.
- As required by HUD, Hartford Insurance, and BMF, DM Jones and AVA Construction formed a joint venture (AVA Construction Services DMJ) and showed a combined working capital of 7%, which was clearly in excess of the requirement. As noted above, the dissolution of the joint venture was unforeseen and unauthorized, and it occurred without HUD's or BMF's knowledge.
- The negative profit noted in the 2002 financial statement for DM Jones (-\$34,450) and AVA (-\$138,717) was a result of their pending accounts receivable for their respective projects at that point in time; however, they had retained earnings of \$913,837 and \$692,967, respectively. Based on the financial statement provided for both DM Jones and AVA Construction, each company had stable retained earnings averaging \$915,851 and \$659,405, respectively.

OIG ASSERTION:

- Without the appropriate credit reports and complete financial statements, the lender did not make an accurate determination as to whether the borrowers or the general contractor had the financial wherewithal to develop, build and complete the project.

RESPONSE:

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- From reviewing BMF's underwriting files from 2002/2003, it is clear that the partnership was structured to leverage each participant's respective strengths. In this respect, it appears that the central financial wherewithal to develop, build and complete the project was intended to be provided by PFG and that the GC had sufficient wherewithal to complete its designated tasks.
 - i. KREG, LLC / Emmanuel Ogundipe provided:
 - Day-to-day site control;
 - Tenant Relationships;
 - Strong relationship with the housing authority, DCHFA; and
 - Current experience with DM Jones Construction on Fort Chaplin Park Apartments, a 549 unit tax credit property, in the immediate submarket of Anacostia that was successfully renovated in 2000 and included relocation of tenants.
 - ii. Protech Holdings R, LLC (member of GP) owned by PFG Holdings provided:
 - Development and ownership experience through affiliated entities of more than 190 multifamily projects of which 17,000 units were to low-income tenants and 12,000 units were sub-rehabbed; and
 - Project oversight – Section 3.1 of the Operating Agreement for Wingate Development, LLC (GP) included approval rights on all decisions and required their consent on major decisions.
 - iii. PFG Holdings Corp (100% Shareholder of the Tax Credit Entity) and manager/member of Protech Holdings R, LLC (co-General Partner of Wingate Development, LLC) provided:
 - Financial strength and control over operating decisions at the property; and
 - The required equity of \$10+ million, as well as an additional \$24.7 million.
- 2. "The lender did not accurately evaluate the sponsor's, co-general partner's and general contractor's experience." In support of this statement, the following assertions are made:

OIG ASSERTION:

- The sponsor's resume indicated limited management experience with multifamily insured projects and no ownership experience. As a result, the managing general partner could not resolve construction issues that occurred during the rehabilitation, nor could they contribute financially.

RESPONSE:

- BMF did not look to KREG, LLC or Emmanuel Ogundipe for the development/ownership experience as they required that Protech Holdings R, LLC hold a member interest in Wingate Development, LLC (General Partner) and further required the Operating Agreement contain approval rights on all decisions and mandatory consent on key decisions.
- As noted on the 2530's for AMTAX Holdings 194, LLC, PFG and its affiliated entities had development and ownership experience on more than 190 multifamily

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projects to include 17,000 units on low income and 12,000 units on sub-rehabilitated assets.

OIG ASSERTION:

- o The general contractor's resume did not provide complete information indicating sufficient experience with rehabilitating a multifamily insured project and failed to show the size of the projects completed and role of the general contractor on each project.

RESPONSE:

- o DM Jones Construction was formed in 1995 and has renovated more than 30 multifamily projects.
- o DM Jones Construction completed a 549 unit sub-rehab with the DCHFA and Emmanuel Ogundipe in 2000 in the immediate sub-market on Fort Chaplin Park Apartments, which are now 97% occupied (as confirmed by Fort Chaplin Apartments to DBBM on January 25, 2011).
- o AVA Construction was formed in 1986 and had provided sub-contracting services, including a HUD financed multifamily property with 300 units in DC (Greenway Apartments). AVA had also provided services at Spring Creek Apartments, a 600 unit property in Memphis, Tennessee.
- o DM Jones Construction and AVA Construction were reviewed and approved by DCHFA, HUD, the Hartford Company, and BMF.

OIG ASSERTION:

- o The lender did not consider the past multifamily experience of the co-general partner, whose three prior projects had failed.

RESPONSE:

- o The Form HUD-2530 provided in 2002 for the pre-application noted Michael J. Menzer as the President/Director of PFG.
- o Mr. Menzer, on page 17 of the 2530, listed three assets in West Virginia constructed in 1988 for which Mr. Menzer had served as the non-managing co-general partner for an affiliated sponsored tax credit investment partnership. The three assets were deeded in lieu of foreclosure to the lender in 1993. These defaults occurred ten years prior to BMF's Firm Application submission in May of 2003.
- o An updated 2530 was provided in 2003 with the Firm Application and Mr. Menzer was no longer listed as the President/Director of PFG. As noted on the 2530, Michael A. Buckley assumed this position.
- o As noted on the 2530's, PFG and its affiliated entities had ownership/development interests in more than 190 multifamily assets and, as noted above, only three known defaults, which occurred over ten years ago.

OIG ASSERTION:

- o The lender incorrectly asserted that both the sponsor and general contractor had adequate experience and HUD relied on the lender's recommendation.

RESPONSE:

- o The mortgage credit appears to have been structured by BMF to leverage each participant's strength: Emmanuel Ogundipe provided the required relationships; PFG and its related entities provided the necessary extensive ownership/development

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experience; and the tax credit investor, supported by GMAC, provided the financial strength.

- i. In this connection, BMF required the Operating Agreement to be structured such that PFG provided the development/ownership experience. Section 3.1 of the Operating Agreement for Wingate Development, LLC (GP) included approval rights on all decisions and required PFG's consent on major decisions.
- ii. PFG provided the development and ownership experience through affiliated entities with development/ownership/management experience on more than 190 multifamily projects of which 17,000 units were to low-income tenants and 12,000 units were sub-rehabbed.

3. "The lender failed to ensure that the scope of work included all needed repairs." In support of this statement, the following assertions are made:

OIG ASSERTION:

- o The lender failed to ensure that asbestos removal and other needed repairs were included in the scope of work, and the general contractor was not aware of the additional costs.

RESPONSE:

- o Page 49 of the A&E Cost Report notes that the asbestos removal is part of the proposed work.
- o The areas identified for asbestos removal in the Asbestos Report prepared by Law Engineering were covered under the scope of rehabilitation identified in the A&E Cost Report / 2328.
- o With respect to repair work more generally, unanticipated crime issues and related expenses hindered both repair and construction work. Numerous improvements were damaged and had to be re-repaired or restarted. BMF's Pre-Application, Firm Application and the LQMD report all noted significant issues with crime in the area that impacted security concerns at the property.
- o As the LQMD noted that the current operating statement reflected security expenses 10 times greater than projected at underwriting.
- o The Firm Application also spoke to a commitment by the city of Washington, DC to spend \$847 million to redevelop the Anacostia area; DBBM has researched the proposed improvements, however, and notes that, as of the date of this response, the majority of the promised Anacostia area improvements have not been completed. As a result, crime-related expenses exceeded estimates.

OIG ASSERTION:

- o The general contractor submitted ninety-nine change orders, resulting in substantially increased costs. Construction costs totaled more than \$70 million rather than the original estimate of \$26 million.

RESPONSE:

- o As noted in the Pre-Application, Firm Application, and the LQMD prepared by HUD in January 2009, the subject neighborhood consists of a low-income demographic that has pervasive challenges with crime and security.

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Comment 14

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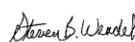
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- o DBBM has analyzed the change orders and notes that numerous requests were associated with tenant damage.
- o The LQMD team noted during their August 8, 2008 inspection that the tenants expressed security concerns.
- o The LQMD audit noted that the security expense was 10 times the underwritten expense.
- o Due to the level of crime in the area and at the property, the improvements were repeatedly damaged and had to be replaced at additional cost.
- o DBBM followed-up on the \$847 million redevelopment initiative by the City of Washington, DC in the Anacostia area slated to be completed over a 5-year period beginning in 2002 and found that the majority of the improvements were not completed. As a result, crime-related expenses exceeded estimates.

Conclusion

As noted above, DBBM appreciates the opportunity to review and comment on the Draft Report. As indicated at the outset, however, we are deeply concerned by the allegations that DBBM is responsible for the actions of a different entity, the chilling effect this will have both on the demand for FHA multifamily servicing rights and on the willingness of lenders to engage in HUD-recommended development projects in challenged locations, and finally the lack of factual basis to the findings and recommendations in the Draft Report. Accordingly, we request that the findings be dismissed with respect to DBBM. DBBM's commitment to compliance with HUD regulations and policies is unwavering, and we believe our compliance is clearly evidenced based on the responses we have provided.

Sincerely,


Digitally signed by
Steve Wendel
Date: 2011.02.08
18:03:05 -05'00'

Steven B. Wendel
Managing Director
Deutsche Bank Berkshire Mortgage, Inc.

OIG Evaluation of Auditee Comments

Comment 1 The Lender's overall underwriting history was not the subject of this audit.

Comment 2 The audit was performed at the offices of the Lender that acquired the loan origination files and personnel who underwrote and serviced the \$45.6 million FHA-insured loan that was the subject of this audit. HUD paid the Lender \$44.3 million in an FHA insurance settlement and sold the mortgage note for \$14.5 million, a loss of \$29.8 million to the taxpayer.

On October 21, 2004, GACC purchased the mortgage banking, brokerage, lending, and servicing business of the Underwriter. After the asset purchase by GACC, the Underwriter's business was continued by a GACC affiliate named Deutsche Bank Berkshire Mortgage, Inc. (the Lender), which took over the Underwriter's offices, files, and employees. On February 7, 2005, the Underwriter changed its name to Berkshire Mortgage Finance Limited Partnership Liquidation (BMFLP Liquidation). An attorney representing BMFLP Liquidation informed us that the company exists for the sole purpose of providing security against losses to GACC. Although it technically is an existing entity, BMFLP Liquidation has no employees and is not actively engaged in business. Since the GACC acquisition, BMFLP Liquidation has not maintained audited financial statements.

During the audit, we conducted interviews with the responsible staff who continued to work for the Lender, including the originating underwriter and construction specialist. We also reviewed the complete loan file for the Wingate Towers and Garden Apartments loan. We have made changes to the report to address the Lender's concerns that the underwriting problems occurred prior to its acquisition of the loan. After the audit exit conference, the Lender provided documents which it asserted relieved it of any legal liability for the poor underwriting of the company it acquired. Therefore, we have added a recommendation for HUD to perform a legal review of these documents to determine the legal liability of the responsible party involved in these transactions. We have also revised the other two recommendations to include any parties who are ultimately determined to be legally responsible for incorrectly certifying that due diligence was exercised in the underwriting of this loan.

Comment 3 We are not aware of the existence of such a report. Also, HUD's Office of Multifamily Development again informed us it was not aware of the existence of such a report.

Comment 4 HUD's approval of the Wingate Towers and Garden Apartments loan application was based on the Underwriter's certification that the loan was feasible and would not be a risk to the FHA fund.

Comment 5 We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. The audit evidence clearly showed that the Underwriter failed to properly assess, as required, the financial wherewithal of the owner and general contractor, or the construction capabilities of the general contractor. The Underwriter also significantly understated the amount of repairs needed to bring the property up to marketable condition. Based on the Underwriter's recommendation, HUD approved the project and the general contractor. The project failed, resulting in a loss of \$29.8 million to the taxpayer. HUD's Office of Multifamily Development also reviewed the underwriting of this loan and similarly reported in February 2009 that serious underwriting deficiencies resulted in the loan default. Specifically it reported that the Lender failed to

- properly scrutinize the experience and creditworthiness of the owner and general contractor, directly contributing to the project's failure, and
- ensure the scope of work was sufficient to bring the property up to marketable condition.

Comment 6 Since the sponsor and affiliated principals' companies were newly formed and had no operating history, the Underwriter was required to obtain individual credit reports of responsible parties. The Lender acknowledges that the Underwriter did not obtain individual credit reports. The Lender provides other unverified information here but does not explain how it negates a failure to comply with the applicable HUD underwriting requirements designed to ensure that the loan was feasible and would not be a risk to the FHA fund.

Comment 7 The MAP Guidebook required that all sponsors, principals and general contractors complete HUD Form 92013 to document that the credit references included bank, trade, and other credit information. The Underwriter did not ensure that the forms were completely filled out as required and did not verify the information required on the forms. For example, one of general contractors listed six trade references and only one trade reference was verified. The Underwriter also did not ensure that a verification of deposit be present for each bank reference listed. The Lender provides other unverified information here but does not explain how it negates a failure to comply with the applicable HUD underwriting requirements designed to ensure that the loan was feasible and would not be a risk to the FHA fund.

Comment 8 The MAP Guidebook required that the sponsor, mortgagor and general contractors provide financial statements and supporting schedules for the last 3 years of existence. One of the project's general contractors was not required to

adhere to HUD's requirement. The Lender acknowledges that the Underwriter did not require that both general contractors submit the supporting schedules as required. The Lender provides other unverified information here but does not explain how it negates a failure to comply with the applicable HUD underwriting requirements designed to ensure that the loan was feasible and would not be a risk to the FHA fund.

Comment 9 The financial documentation dates for the joint venture financial statements used in the working capital calculation were 58 days apart. The working capital analysis is used to determine the difference between the general contractor's assets and liabilities. The Underwriter could not have accurately determined whether there was adequate working capital for the Wingate Towers project since the financial documentation did not have the same cutoff dates.

Comment 10 Although the Lender asserts that there was adequate leverage of financial commitment and experience of the principals and sponsors to complete the project, the project ultimately failed. The sponsor did not have adequate experience to provide day-to-day site control of the property. As discussed in the audit report, both the sponsor and the general contractors had limited experience with multimillion dollar projects. The MAP Guidebook required that the financial capacity and experience be considered by the Lender to determine if the sponsor and general contractor had the capacity to develop, build, and complete the project. The MAP Guidebook also required that the Underwriter pay close attention to the type and sizes of projects, length of time served in capacity, and past roles in multifamily businesses of the sponsor. The sponsor's resume did not demonstrate the level of experience needed to successfully complete the development of the project.

Comment 11 The general contractor's resume did not provide complete information indicating sufficient experience and did not provide the size of the projects completed. Although the Lender asserts that one of the general contractors recently assisted with a project in the District of Columbia, the project that has been mentioned had total rehabilitation costs of \$4 million. The Wingate Towers and Garden Apartments project originally cost approximately \$46 million due to substantial rehabilitation. The general contractor did not have enough experience to rehabilitate the project, thus a joint venture was formed. However, per records reviewed, the joint venture disbanded 2 days before initial endorsement. Thus, the less experienced general contractor was to complete the project. The general contractor could not complete the project and was ultimately removed from it.

Comment 12 The audit report has been revised based on information provided at the exit conference and now does not include the results of the past multifamily project experience of one of the Wingate Towers and Garden Apartments' loan's co-general partner.

Comment 13 Although the Lender asserts that the property failed due to crime and other area improvements that did not take place, our review of the underwriting of the loan showed severe deficiencies with the credit investigation, experiences of its owners and inadequate scope of work. We cannot confirm the Lender's assertion that the property failed because other financial commitments did not materialize.

Comment 14 The change orders included requests for extensions to complete the project and the replacement of drywall, flooring and doors. Only a small amount of change orders were associated with tenant damages.