Audit Report

Baltimore County Settlement Expense Loan Program (SELP)

Office of the County Auditor
Baltimore County, Maryland
October 2000

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October 13, 2000

Honorable Members of the County Council
Honorable C.A. Dutch Ruppersberger, III, County Executive
Baltimore County, Maryland

Gentlemen:

We audited the Baltimore County Settlement Expense Loan (SELP) Program as administered by the Office of Community Conservation for the period beginning July 1, 1997 and ending June 30, 1999.

Settlement expense loans were issued primarily through four Housing Counseling Agencies (HCA) - the Eastern Baltimore Area Chamber of Commerce, Harbel Community Organization, Inc., Neighborhood Housing Services, Inc., and Associated Catholic Charities. During the period July 1, 1997 through June 30, 1999, Federal funds allocated to the Program totaled approximately $2.9 million. Of this amount, the County advanced approximately $2.6 million to HCAs who issued 533 loans totaling more than $2.3 million.

Our audit disclosed instances of noncompliance with Program guidelines and procedures as well as internal control weaknesses over Program transactions. Specifically, we noted that verification of occupancy, income eligibility, and hazard insurance was not being performed as required. Additionally, Program resources (e.g., Federal funds, loan repayments) were not maximized to fund additional SELP loans. Finally, our tests of transactions disclosed that cash receipts were not always deposited timely, and internal control was inadequate to detect and prevent errors or fraud and to ensure that authorized transactions were properly recorded.

A response to our findings from the Office of Community Conservation is included as Appendix A to this report.

Our audit reports and responses thereto are available to the public and may be obtained by contacting the Office of the County Auditor, 400 Washington Avenue, Towson, Maryland, 21204, or by accessing our Office web page from the County's web site at "www.co.ba.md.us."

We wish to express our appreciation to the Office of Community Conservation, the Office of Budget and Finance - Financial Operations Division, and the aforementioned Housing Counseling Agencies for the cooperation and assistance extended to us during our audit.

Respectfully submitted,

Brian J. Rowe, CPA
County Auditor

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Background Information

Creation of new homeowners in Baltimore County has been a continuing goal of the current Administration, particularly within the County's older neighborhoods which are a part of the designated Community Conservation areas. In an effort to promote home ownership and support education programs for first-time home buyers, the County, through the Office of Community Conservation, initiated the Settlement Expense Loan Program (SELP) in January 1995. The Program is funded by Federal Home Investment Partnerships Program (HOME) funds received from the Federal Department of Housing and Urban Development.

SELP funds provide closing cost assistance in the form of deferred repayment loans to buyers whose household income is below 80% of the median for the metropolitan area. For example, 80% of the median income in Baltimore County for a family of four was $47,800 as of February 9, 1999. The Program is administered through a network of nonprofit Housing Counseling Agencies (HCA) who educate and counsel prospective buyers before recommending them for a loan. Loans may not exceed $5,000 and are secured by a second mortgage repayable at the time of sale or refinance of the property, or once the buyer ceases to occupy the premises as a principal residence. Upon repayment, the County requires the principal balance plus 5% interest for the first year that the loan is outstanding. SELP loans are limited to the purchase of existing homes within the designated Community Conservation areas.

Since the Program's inception in January 1995 through June 30, 1999, the County authorized 1,116 SELP loans totaling more than $4.8 million (with loans averaging $4,325). During the two-year audit period beginning July 1, 1997 and ending June 30, 1999, Federal HOME funds allocated to the Program totaled approximately $2.9 million and the County issued 533 SELP loans totaling more than $2.3 million. Loan repayments, including applicable accrued interest, totaled approximately $241,000 during the audit period.

Loan files are maintained by the Office of Community Conservation and all financial transactions related to the Program are processed and recorded by the Office of Budget and Finance.

Findings and Recommendations

Program Guidelines and Procedures

1. **Residency requirements were not verified.**

Settlement Expense Loan Program (SELP) Guidelines and Procedures require the borrower to occupy the property as their primary residence. Failure to do so constitutes default of the loan, requiring immediate repayment. The guidelines further provide that the Office of Community Conservation or the Housing Counseling Agency (HCA) will periodically “spot check” occupancy status to ensure compliance with the loan requirements. However, our audit disclosed that the required occupancy verifications were not performed. Consequently, there was a lack of assurance that all Program participants (borrowers) were complying with loan provisions by occupying the property as their primary residence.

We recommend that the Office periodically verify that borrowers occupy the property as their primary residence in compliance with SELP guidelines and procedures.

2. **Borrower income eligibility was not verified as required.**

SELP Guidelines and Procedures require the borrower to meet income eligibility criteria at the time of applying for the SELP loan as well as on the day of closing. Income limits are established by the U.S. Department of Housing and Urban Development (HUD) to target individuals who exhibit financial need. Although income eligibility was verified during the application process, our audit disclosed that household income was not verified by the lender or the housing counselor on the day of closing to ensure that borrowers remained income eligible. As a result, there was a lack of assurance that borrowers remained eligible for the loans.

We recommend that the Office verify that the borrower is income eligible on the day of closing in compliance with SELP guidelines and procedures.

3. **Proof of hazard insurance was not obtained.**

Settlement Expense Loan Program (SELP) Guidelines and Procedures require title companies to provide the County with a copy of the hazard insurance certificate (with the County named as additional mortgagor and loss payee) for each property purchased through the Program. However, our audit disclosed that copies of hazard insurance certificates were not obtained. Consequently, there was a lack of assurance that the County was properly insured against the risk of loss if a property was damaged or destroyed without adequate insurance.

To adequately protect the County's financial interest, we recommend that the Office obtain a copy of the hazard insurance certificate for each property purchased through the Program in compliance with SELP guidelines and procedures. We further recommend that the Office verify that the County is named as an additional mortgagor and loss payee.

4. Surplus loan funds were not returned to the County on a timely basis.

Contracts between the County and Housing Counseling Agencies (HCA) required HCAs to maintain a separate accounting of SELP loan funds and to reconcile the account within 60 days of the end of the fiscal year, remitting to the County all surplus funds on deposit as of the fiscal year end. Surplus funds represent the difference between County funds advanced to the HCA (typically $5,000 per loan) and the actual loan amount as determined at settlement. Our audit disclosed that surplus loan funds totaling $74,466 on deposit at June 30, 1999 (for FY 1999) were not returned to the County until November 1999, approximately 120 days after the end of the fiscal year. Additionally, one Housing Counseling Agency (Eastern Baltimore Area Chamber of Commerce) accumulated surplus loan funds totaling $23,889 through FY 1998 that were not returned to the County.

This condition precluded effective fiscal management which requires timely remittance of year-end surplus loan funds to maximize available County resources and to encourage prudent management of SELP accounts maintained by Housing Counseling Agencies.

We recommend that the Office ensure that Housing Counseling Agencies reconcile their respective loan fund accounts within 60 days of the end of the fiscal year, remitting to the County all remaining surplus funds on deposit as of the fiscal year end as required by contract.

Program Income

5. Federal reimbursement for SELP loans was not obtained on a timely basis.

SELP loans are initially made using County funds. Typically, the County issues a monthly check to each Housing Counseling Agency for loans expected to be settled within 30 days. Since actual settlement costs are unknown, $5,000 (the maximum allowed for a SELP loan) is allotted for each loan. After settlement, the actual loan amount is reported to the County and Federal HOME funds are requested as reimbursement for the loan. Surplus loan funds, representing the difference between $5,000 and the actual amount of each loan, are used to offset future requests for funds from the County. The Office of Community Conservation advised that 120 days from the date of settlement allows reasonable time to record, review, and process loan information to initiate the request of Federal funds as reimbursement for a loan. However, our audit disclosed several instances where

Federal reimbursement was not obtained within the 120 day period. Specifically, our test of 30 loans valued at $127,841 disclosed that for 13 loans totaling $52,082, Federal reimbursement was not obtained for periods ranging between 134 days and 388 days. This condition precluded effective fiscal management since County funds were required for extended periods when other financing sources (i.e., Federal Home Loan Funds) were available.

To improve fiscal management, we recommend that the Office obtain Federal reimbursement for SELP loans on a timely basis (e.g., no more than 120 days from the date of settlement) to minimize the use of County funds.

6. Program resources were not maximized.

The U.S. Department of Housing and Urban Development (HUD) authorized the County to treat SELP loan repayments as Program income to be used for additional HOME projects. Accordingly, loan repayments were budgeted as Program income to support additional Program expenditures (i.e., SELP loans). Since the Program's inception in FY 1995, the County received loan repayments totaling $247,599 ($128,579 in FY 1999, $112,777 in FY 1998, and $6,243 in FY 1997). However, our audit disclosed only one instance (FY 2000) when loan repayments (totaling $201,000) were budgeted as Program income to provide additional SELP loans. Consequently, Program funds totaling $46,599 (or 9 additional loans) were not available for Home Projects.

To maximize Program resources, we recommend that loan repayments be budgeted as Program income by the following fiscal year to fund additional SELP loans.

Program Transactions

7. Cash receipts were not deposited daily.

Settlement Expense Loan Program (SELP) Guidelines and Procedures require repayment of the loan principal plus applicable accrued interest upon the sale or transfer of the property or discontinuance of borrower occupancy, whichever occurs first. Repayments are deposited into a County bank account and recorded as Program income. During the audit period, the Office of Community Conservation received 58 SELP loan repayments totaling $241,356 (the average check received totaled $4,161). Our audit disclosed that loan repayments received by the Office were not deposited on a daily basis. Specifically, our test of 16 repayments totaling $64,164 disclosed that 13 repayments totaling $51,214 were not deposited for periods ranging between 1 to 6 business days.

To improve internal control, we recommend that cash receipts for loan repayments be deposited daily.

8. One employee was responsible for all aspects of the cash receipts process.

During the audit period, the Office received loan repayments totaling $241,356 and year-end surplus loan funds totaling $244,623. Our audit disclosed that the employee who was responsible for receiving and recording all collections was also responsible for making all deposits and reconciling the related collections to the amounts deposited. This situation precluded effective internal control since errors or fraud could occur without detection.

To improve internal control, we recommend that the employee responsible for receiving and recording cash receipts not be responsible for depositing and reconciling the related collections. We advised the Office how to accomplish the needed separation of duties utilizing existing personnel.

9. Program transactions were not reconciled to County financial records.

The Office of Community Conservation maintains an accounting of Settlement Expense Loan Program (SELP) transactions including Federal funds allocated to the Program, loans made, repayments received, and surplus loan funds remaining at year-end. The Office of Budget and Finance, Financial Operations Division, is responsible for recording SELP transactions (as reported by the Office of Community Conservation) in the County's financial records. Our audit disclosed that Program personnel did not reconcile Program transactions during the audit period to the County's financial records to ensure that all transactions were properly accounted for. In this regard, our reconciliation of the County's financial records with the Program transactions during the audit period, disclosed that advances to Housing Counseling Agencies per Program records totaled approximately $2.6 million; however, the Financial Operations Division recorded advances totaling only $2 million, or $600,000 less.

To improve internal control, we recommend that the Office periodically reconcile its accounting of financial transactions for the Program to the related financial records maintained by the County's Office of Budget and Finance, Financial Operations Division. We further recommend that all differences be promptly investigated and resolved.

10. Independent verification of loan repayments to amounts deposited were not performed for mortgages that were released.

SELP loans become fully repayable to the County upon certain conditions including the sale of the property. As such, Baltimore County holds a secured interest (i.e., second mortgage) on all properties purchased through the Program. Once a loan is repaid, Program personnel submit a written request to the County Administrative Officer to authorize the release of the second mortgage. Our audit disclosed, however, that there was no independent verification that for each mortgage released by the Office, the related loan repayments were received and deposited. This condition precluded effective internal control over loan repayments since mortgages could be released without assurance that the related loan repayments were received and deposited. During the audit period, the Office of

Community Conservation received 58 loan repayments (totaling $241,356) that required a Release of Mortgage.

To improve internal control, we recommend that for each mortgage released by the Office, an independent verification be performed to verify that the related loan repayments were received and deposited.

Audit Scope, Objectives and Methodology

We audited the procedures and controls for the Settlement Expense Loan Program (SELP) administered by the Office of Community Conservation for the period beginning July 1, 1997 and ending June 30, 1999. The audit was conducted in accordance with generally accepted government auditing standards.

As prescribed by the Baltimore County Charter, Section 311, the objectives of our audit were to evaluate the Program's fiscal activities, including the internal accounting control, administrative and operating practices and procedures, and other pertinent financial and compliance matters. In planning and conducting our audit, we primarily focused on compliance with applicable County and Federal guidelines and procedures based on assessments of materiality and risk.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of the Program's operations. We also tested loan transactions and performed other auditing procedures as we considered necessary in the circumstances to achieve our objectives.

The Program's management is responsible for establishing and maintaining an internal control structure. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded and that transactions are processed and properly recorded in accordance with management's authorization. Because of inherent limitations in any internal structure, errors or fraud may nevertheless occur and not be detected. Compliance with applicable laws, rules, regulations, policies, and procedures is also the responsibility of the Program's management.

Our reports on fiscal compliance are designed to assist the Baltimore County Council in exercising its legislative oversight function and to provide constructive recommendations for improving County operations. As a result, our reports do not address activities we reviewed that may be functioning properly.

This report includes findings and recommendations relating to conditions that we consider to be significant deficiencies in the design or operation of the internal control structure that could adversely affect the Program's ability to safeguard assets or properly record authorized transactions. This report also includes findings and recommendations relating to instances of noncompliance with applicable laws, rules, regulations, policies, and procedures.

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Office of Community Conservation

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September 28, 2000

Response to Compliance Audit-Settlement Expense Loan Program (SELP)
The Office of Community Conservation has completed the review and response to the Fiscal Compliance Audit period of July 1, 1997 ending June 30, 1999 from the Office of the County Auditor. The Office of Community Conservation now respectfully submits our response to the audit findings and recommendations to be included as an appendix in the final report.

1.) Residency requirements to be verified.
2.) Borrower income eligibility was not verified at settlement.

Response to 1 and 2
Included in the SELP settlement package is a borrower's affidavit to be executed at settlement. The borrower affirms that the borrower will occupy the property as a principal residence, during the life of the loan and the document also serves to verify household income at the day of settlement. This is to ensure that borrower(s) remain income eligible. In the future to address residency, the office has started an internal procedure to send post cards (at random selection) to homeowners with SELP mortgages to verify continued residency. This post card will be postage paid return survey. **(See attachment: Borrower's Affidavit and post card draft)**

3.) Proof of hazard insurance not obtained.

Response to 3
The SELP loan position as second mortgage results in excess loan to property value, as a result we do not require to be listed as loss payee because of the lack of equity. The first mortgage holder requires hazard insurance at settlement and monitors this for the life of the loan (verified by HUD 1 in settlement package). The County's financial interest is increased as the first mortgage amount decreases from the borrower(s) payments and the recorded second mortgage (SELP) against the property. The requirement of the county listed on the insurance binder has been removed from SELP policy and procedures, however we verify from lender documents prior to settlement that the borrower has purchased hazard insurance and would decline the SELP loan if otherwise. **(See attachment: SELP Program Guidelines and Procedures)**

4.) Surplus loan funds were not returned to the County on timely basis.
5.) Federal reimbursement for SELP loans was not obtained on a timely basis.
6.) Program resources were not maximized.

Response to 4, 5, and 6
To streamline line our internal accounting of SELP loan surplus funds we now require quarterly reporting from the Housing Counseling Agencies, along with the monthly surplus ledgers this improved our accounting at fiscal year end reporting. Additionally the office has implemented the internal process of an immediate review of incoming SELP loan documents. The documents which are returned to the County after settlement from the Title Company allows the office to reconcile any errors by the Title Company after a review of the HUD I and we have determined the loan is in compliance with the program guidelines. With the above process in place this allows for a more timely response to meeting the federal reimbursement accounting with our grants administer and to maximize the program resources with the most recent reconciled accounting of funds.

7.) Cash receipts were not deposited daily.
8.) One employee was responsible for all aspects of the cash receipts process.

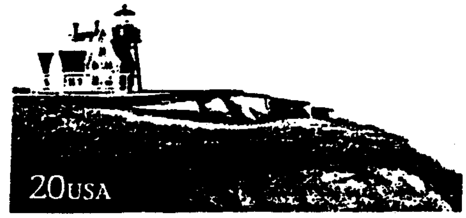
Response to 7 and 8
Based on the available staff in the housing office, a daily rotation between two staff persons will either open and record the mail, or make the daily deposit of cash receipts during the hours of 2-3:00 p.m.

9.) Program transactions were not reconciled to the County financial records.

Response to 9
With our internal process in place (see 4,5, and 6) for a more timely reconcile period with the housing groups we can begin a quarterly reconcile with the Office of Budget and Finance, Financial Operations Division of the financial transactions so that program resources can be better maximized.

10.) Independent verification of loan repayments to amounts deposited was not performed for mortgages that were released.

Response to 10
The internal process in place to verify payments received for a release of lien, is to document payment received by attaching a copy of the payoff check received to the request of release signed by the administrative office.



Baltimore County Office of Community Conservation
Settlement Expense Loan Program (SELP)
1 Investment Place, Suite 800
Towson, MD 21204

Baltimore County is required to verify residence occupancy from homeowners that have received any closing cost assistance from our first time homebuyers program (SELP).

Please complete and return this postage paid card at your earliest convenience.
SELP LOAN #: __________

____/____ I/We now occupy the property as my/our principle residence.
Property Address:

Signature: ____________________________ Date: ___________

Signature: ____________________________ Date: ___________

PROPERTY CRITERIA

1. The property being purchased may be an existing single family detached or semi-detached dwelling, townhouse, or condominium apartment. **New construction is excluded.**

2. To avoid involuntary displacement of occupants, at the time of contract the property being purchased must be:
   a. Vacant
   b. Occupied by the seller
   c. Occupied by the buyer of the real estate transaction under the terms and conditions of a valid State of Maryland rental agreement For a period of no less than 90 days

   (The seller will be required to sign an Affidavit of Voluntary Sale at closing so certifying.)

3. The purchase price of the home cannot exceed the appraised value of the property.

4. The property must be located within the Baltimore County Community Conservation Area as designated in the County's Master Plan. This can generally be described as the inner ring of suburban County communities, and excludes the designated growth areas of White Marsh and Owings Mills, as well as the rural areas.

5. Within sixty (60) days of closing, the property must be occupied as the primary residence of the borrower. Failure to do so is default of the loan and will cause the loan to be declared immediately repayable. The County or the housing counseling organization periodically does spot-checking of occupancy.

6. The property must be inspected and certified to meet federal Housing Quality Standards (HQS). The inspection must be conducted by one of the pre-qualified and trained home inspection firms on a list issued by the County. **All noted HQS deficiencies must be corrected and verified by re-inspection** at least seven (7) days prior to scheduled closing. SELP approval cannot be finalized until such certification is received by Baltimore County.

7. The property must have the necessary flood insurance, if applicable, as confirmed by Federal Emergency Management Agency (FEMA) Maps. The first mortgage appraisal will show the flood zone status and HUD I prepared by the Title Company will indicate the standard hazard insurance information or if flood insurance is required and obtained.

LOAN TERMS

1. The first mortgage loan obtained by the purchaser must be a fixed rate loan; no ARM's are permitted in conjunction with SELP. "3-2-1 buy-down" mortgages are only permitted if the applicant has been qualified at the third year rate.

2. The maximum SELP Loan is $5,000; the minimum is $1,000. The actual amount of a SELP loan is calculated by subtracting the buyer's minimum cash contribution from actual closing costs. SELP funds the gap.