U.S. Department of Housing and Urban Development

Office of Inspector General

451 7th St., SW

Washington, DC 20410

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MEMORANDUM FOR: Shaun Donovan, Secretary, S

Michael P Stephens

FROM: Michael P. Stephens, Acting Inspector General, G

SUBJECT: Management and Performance Challenges

In accordance with Section 3 of the Reports Consolidation Act of 2000, the Office of Inspector General (OIG) is submitting its annual statement to you summarizing our current assessment of the most serious management and performance challenges facing the U.S. Department of Housing and Urban Development (HUD or the Department) in fiscal year 2011. Through our audits, investigations, inspections, and evaluations, we work with departmental managers in recommending actions that best address these challenges. More details on our efforts in relation to these issues can be found in our Semiannual Report to Congress.

The Department's primary mission is to create strong, sustainable, inclusive communities and quality, affordable homes for all. HUD seeks to accomplish this mission through a wide variety of housing and community development grant, subsidy, and loan programs. Additionally, HUD assists families in obtaining housing by providing Federal Housing Administration (FHA) mortgage insurance for single-family and multifamily properties. HUD relies upon numerous partners for the performance and integrity of a large number of diverse programs. Among these partners are cities that manage HUD's Community Development Block Grant funds, public housing agencies that manage assisted housing funds, HUD-approved lenders that originate and service FHA-insured loans, Government National Mortgage Association (Ginnie Mae) mortgage-backed security issuers that provide mortgage capital, and other Federal agencies with which HUD coordinates to accomplish its goals. HUD also has a substantial responsibility for administering disaster assistance programs. Currently, HUD is also administering new mortgage assistance and grant programs in response to the Nation's financial crisis, increase in foreclosures, and declining home values.

Achieving HUD's mission continues to be an ambitious challenge for its limited staff, given the agency's diverse programs, the thousands of intermediaries assisting the Department, and the millions of beneficiaries of its housing programs. The continuing national credit and financial crisis is having a profound impact on HUD. Proposed and new program changes have introduced new risks and enforcement challenges. More specifically, the $13.6 billion American Recovery and Reinvestment Act of 2009 (Recovery Act) increased the oversight responsibilities for the Department for the next 2 years. In addition, Congress allotted another $1 billion to the Neighborhood Stabilization Program and $1 billion to the new Emergency Homeowners Loan

Program to help homeowners who have become unemployed or underemployed keep their homes. HUD is also a key to the Nation's mortgage industry where the market share of FHA-insured mortgages has increased dramatically from 1.9 percent in 2006 to 30 percent in 2010. The attachment discusses these and other challenges facing HUD.

Attachment

Attachment

HUD Management and Performance Challenges
Fiscal Year 2011 and Beyond

Single-family programs. FHA's single-family mortgage insurance programs enable millions of first-time borrowers and minority, low-income, elderly, and other underserved households to realize the benefits of home ownership. HUD manages a growing portfolio of more than $873 billion in single-family insured mortgages. Effective management of this portfolio represents a continuing challenge for the Department.

HUD has sustained significant losses in its single-family program and is taking on additional risk. The number of FHA mortgages has risen dramatically. The increased mortgage endorsement volume is accompanied by increases in defaults, claims, and loss mitigation. FHA's Mutual Mortgage Insurance (MMI) fund has fallen below the legally required 2 percent capitalization ratio. Recent legislation gave the HUD Secretary more flexibility regarding premiums charged for mortgage insurance. As a result, HUD decided to raise the annual premium and lower the upfront premium to aid in returning the MMI fund to congressionally mandated levels without disruption to the marketplace.

FHA plays a major role in supporting the housing market. The current degree of FHA predominance in the market is unparalleled. It is clear that the Department is committed to positioning FHA as rapidly as possible to deal with the changing dynamics. For the first time, FHA has imposed a minimum credit score to be eligible for FHA financing and set loan-to-value ceilings dependent on credit scoring. We have expressed concerns that the credit score threshold HUD will use is traditionally considered subprime territory in the conventional marketplace. HUD also moved to strengthen its lender population by increasing its net worth requirements (minimum of $1 million). Further, after December 31, 2010, loan correspondents (also referred to as sponsored third-party originators) must establish a sponsorship relationship with an FHA-approved mortgage lender to continue participating in FHA programs.

By law, HUD has to pay the claim on a defaulted FHA-insured mortgage but can go back to the lender and recover the losses incurred if it finds that the loan was ineligible for insurance. OIG has noted in past audits HUD's unnecessary exposure when paying claims on loans that were never qualified for insurance. In the current year, we conducted Operation Watchdog, an initiative that involved reviewing the underwriting of 284 mortgages underwritten by 15 direct endorsement lenders. HUD had paid claims on these loans that resulted or are likely to result in actual losses in excess of $11 million. Our review showed that 140 (49 percent) of the loans reviewed, a large and unacceptable percentage, never should have been insured.

FHA has introduced new loss mitigation programs. HUD and the U.S. Department of the Treasury announced enhancements to the existing Making Home Affordable Program, a refinance program that provides homeowners that owe more on their mortgage than the value of their home opportunities to refinance into an affordable FHA loan. Further, recent legislation provided up to $50,000 to homeowners on their mortgage principal, interest, mortgage insurance, taxes, and hazard insurance for up to 24 months. Eligible homeowners are those that have become unemployed/underemployed. The assistance will be worked through a variety of State and nonprofit entities and will offer a declining balance, deferred payment, zero interest, nonrecourse bridge loan, which HUD will write off if the homeowner stays current on the mortgage for 5 years. Setting up and monitoring this program in the time Congress has allotted will be a challenge.

We remain concerned that increases in demand to the FHA program are having collateral implications for the integrity of the Ginnie Mae mortgage-backed securities program including the potential for increases in fraud in that program. HUD needs to consider the downstream risks to investors and financial institutions eventual securitization of a large proportion of FHA's insured mortgages. Ginnie Mae securities are the only mortgage-backed securities to carry the full faith and credit guaranty of the United States. If an issuer fails to make the required pass-through payment of principal and interest to investors, Ginnie Mae is required to assume responsibility for it. Typically, Ginnie Mae defaults the issuers and assumes control of the issuers' mortgage-backed security pools. Like FHA, Ginnie Mae has seen an augmentation in its market share (it has even in some recent months surpassed both Fannie Mae and Freddie Mac) and guaranteed $412 billion in outstanding mortgage-backed securities during fiscal year 2010 and now has $1 trillion in outstanding mortgage-backed securities.

Oversight of Recovery Act funds. Congress allocated $13.6 billion in funding to HUD programs under the Recovery Act. This allocation added significant funding to the Public Housing Capital Fund, Community Development Block Grants, Neighborhood Stabilization Program, Homelessness Prevention and Rapid Re-Housing Program, and other HUD programs to modernize and "green" the public and assisted housing inventory, support the low-income housing tax credit market, stabilize neighborhoods hit by foreclosures, and prevent homelessness. Carrying out the goals of the Recovery Act, while dealing with the influx of mortgages and refinancing, and conducting its normal operations is a significant challenge.

In general, the Recovery Act directs HUD to ensure that the $13.6 billion is awarded and distributed in a prompt, fair, and reasonable manner; that the recipients' use of funds is transparent to the public; that the funds are used for only authorized activities; that recipients avoid unnecessary delays and cost overruns; and that program goals are achieved, including specific program outcomes and improved results on broader economic indicators. This oversight role is a challenge. Further, HUD must assist all of its recipients in reporting their use of funds on the Recovery Act Web site. HUD also has to ensure that the data the recipients report are accurate. This type of reporting is unprecedented.

During the last two fiscal years we started and completed 88 audits and reviews of Recovery Act-related activities. These audits and reviews addressed the administrative capacity of selected Recovery Act grantees to meet their responsibilities to properly administer these funds. We also assessed HUD's efforts to assess the risks associated with Recovery Act funding along with the Department's plans to mitigate those risks.

Capacity issues of Recovery Act funding recipients will challenge HUD. For example, HUD decided to provide Recovery Act public housing capital funding to authorities it deemed "troubled." Currently, there are 174 troubled authorities that received allocations totaling $350 million in Recovery Act funds, and members of Congress have raised concerns about public housing authorities' abilities to effectively administer Recovery Act funding. HUD developed a troubled public housing agency (PHA) Recovery Act strategy in which it assigned each troubled

PHA a risk level of low, medium, or high. HUD has plans to provide technical assistance, monitoring, and oversight based on these risk levels. During the fiscal year, we reviewed the capacity of 19 authorities, noting that 11 had significant capacity issues. HUD's oversight of the $4 billion in capital funds is a challenge. By March 2010, the PHAs were required to obligate these funds, and they must spend the funds within the next 2 fiscal years, in addition to administering their normal capital fund programs.

The Recovery Act added $2 billion to the Neighborhood Stabilization Program that Congress created as part of the Housing and Economic Recovery Act of 2008, and recent legislation added another $1 billion. HUD administers the now nearly $7 billion program to redevelop abandoned and foreclosed-upon homes. The Recovery Act also added $3.5 billion to community planning and development programs for block grant activities and homelessness prevention. HUD must oversee the expenditure of these funds in the next 2 years. We looked at 28 grantees and subgrantees receiving Recovery Act funds and reported to HUD that 12 had the capacity to handle the increased funding, while 13 needed improvements and 3 lacked capacity.

Human capital management. For many years, one of the Department's major challenges has been to effectively manage its limited staff to accomplish its primary mission. HUD lacks a valid basis for assessing its human resource needs and allocating staff within program offices, as evidenced in OIG's September 2008 audit pertaining to HUD's management of human resources.

The current administration announced a "human capital transformation," noting that the 2008 Federal Human Capital Survey ranked HUD 24th out of the 30 large agencies in the "Best Places to Work in the Federal Government" report (HUD has since moved to last in the 2010 rankings). The Department contracted with the National Academy of Public Administration (NAPA) to consult on this problem. NAPA noted that HUD did not engage in any short- or long-term planning to determine staffing needs. It noted the absence of a clear workforce planning strategy, which is impeding the Department's efforts to address its workforce needs in a strategic, systematic manner.

NAPA recommended that the Department establish an intra-agency team of senior officials, including the Chief Financial Officer, Chief Human Capital Officer, and administrative/budget officials from major program offices, to assess the causes of its erratic resource management practices and develop a more timely and predictable staffing process. NAPA recommended that this team lay the groundwork for creating ongoing, agencywide workforce analysis and planning that is tied to HUD's strategic plan and enhances longer range capability to recruit and sustain a high quality workforce.

Financial management systems. Since fiscal year 1991, OIG has annually reported on the lack of an integrated financial management system, including the need to enhance FHA's management controls over its portfolio of integrated insurance and financial systems. During the past several years, HUD has made progress by partially implementing new core financial systems at FHA and Ginnie Mae and addressing most of the previous weaknesses that OIG identified. These improvements enabled OIG to reclassify the weakness in financial management system requirements from a material weakness to a significant deficiency.

The contract to modernize HUD's financial management systems, the HUD Integrated Financial Management Improvement Project (HIFMIP), was awarded on September 23, 2010. The original scope of HIFMIP was to encompass all of HUD's financial systems, including those supporting

FHA and Ginnie Mae. However, the inclusion of the FHA and Ginnie Mae portions has been put on hold as a result of review by the Office of Management and Budget. HIFMIP was launched in fiscal year 2003 and was to have begun implementation of HUD's core financial system in fiscal year 2006. With the recent award of the contract, HUD anticipates implementation of phase one of the project in time to have all of the fiscal year 2012 financial data within the new system. We continue to note the following weaknesses with HUD's financial management systems:

- HUD's ability to prepare financial statements and other financial information requires extensive compensating procedures.
- HUD has limited availability of information to assist management in effectively managing operations on an ongoing basis.

FHA's business increased dramatically as a result of the mortgage crisis and now accounts for 30 percent of the market share. The shortcomings of the current information technology (IT) systems and the lack of systems capabilities and automation in critical areas of the business are challenging FHA's ability to respond to changes in the market and implement needed changes to its business processes. The recent changes in the economy and the housing market and explosive growth in FHA's single-family insurance program have exacerbated these issues and brought the need to move FHA IT modernization initiatives to the forefront. Critical maintenance had been deferred, and old technology and fragmented architecture are inefficient and expensive to maintain. In August 2009, FHA completed the IT Strategy and Improvement Plan, which identifies FHA's priorities for IT transformation. The plan identifies 25 solution initiatives to address specific FHA lines of business needs. Initiatives are prioritized with the top five being single-family related. The plan also calls for FHA to create a program management office to facilitate coordination and communication and track and report progress, provide support to managers, and support organizational change management activities. Its ultimate goal is to focus leadership effort and resources needed for a successful transformation initiative. HUD has since awarded four contracts under this initiative.

Another IT concern is the ability to replace the antiquated infrastructure on which HUD and FHA applications reside in a timely manner. Workloads have dramatically increased and are processing on systems that are 15 to 30 years old, resulting in performance, flexibility, and interface issues. The use of aging hardware and software can result in poor performance and high maintenance costs. If the IT infrastructure is not modernized, it will become increasingly difficult to maintain operations, make legislative system modifications, and develop or maintain required interfaces to other IT systems, leaving the system environment at risk.

During 2009, HUD unsuccessfully attempted to move certain applications off the antiquated Unisys mainframe onto a modern platform. Computer processing utilization reached the critical rate of 80-90 percent during 2009, which necessitated an upgrade in the processing power of the existing mainframe in May 2009. The upgrade brought the utilization rate down to 60-70 percent. HUD performed another upgrade in June 2010, bringing the utilization rate down further to 35-40 percent. During August 2010, HUD replaced the old Unisys mainframe with the latest model with newer technology. In addition, HUD replaced the antiquated tape drives that were attached to the old Unisys mainframe with virtual tape systems to increase performance.

We continue to report weaknesses in internal controls and security regarding HUD's general data processing operations and specific applications. The effect of these weaknesses is that HUD cannot be reasonably assured that system information will remain confidential, safeguarded, and available to those who need it without interruption.

As part of our annual IT security review mandated by the Federal Information Security Management Act, we found that HUD had not completed all requirements for systems containing personally identifiable information, including categorization and inventory of such systems. Also HUD had not implemented two factor authentications on all enterprise remote access solutions.

Public and assisted housing program administration. HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofit and for profit) and PHAs. These intermediaries, in turn, provide housing assistance to benefit primarily low-income households. The Office of Public and Indian Housing provides funding for rent subsidies through its public housing operating subsidies and tenant-based Section 8 rental assistance programs. These programs are administered by about 4,100 PHAs, which are to provide housing to low-income families or make assistance payments to private owners that lease their rental units to assisted families. In fiscal year 2010, the PHAs assisted 3.2 million low-income households.

HUD has a challenge of ensuring that adequate funding is available to support the Housing Choice Voucher program. In fiscal year 2009, approximately 180 PHAs reported shortfalls in voucher funding. Several factors contributed to the shortfalls. First, the funding Congress provided to renew vouchers for calendar year 2009 was several hundred million dollars less than the amount for which agencies were eligible. Second, tenant incomes declined—most likely due to recent job losses caused by the recession—driving up voucher costs in many regions of the country and worsening the financial crunch. Third, the average cost of a voucher increased more than 5 percent in fiscal year 2009, despite weakening in most rental housing markets. Early in fiscal year 2010, Congress provided HUD $200 million in advance funding to assist PHAs experiencing shortfalls. In total, 182 PHAs received $77 million in additional funding. As a proactive measure, HUD established the shortfall prevention team to ensure that assisted families would not be terminated from the Housing Choice Voucher program. HUD provided technical assistance to these PHAs in identifying cost-saving measures to maximize the funding utilization and prevent termination of families receiving rental assistance.

The Office of Housing administers a variety of assisted housing programs including parts of the Section 8 program and the Sections 202 and 811 programs. The subsidies provided through these programs are called “project-based” subsidies because they are tied to particular properties. Therefore, tenants who move from such properties may lose their rental assistance. For this fiscal year, HUD requested $8 billion for Section 8 project-based rental assistance.

HUD has made improvements in the area of erroneous payments, but more are needed. To continue its efforts in the reduction, it needs to enhance its disclosures of administrative errors made by intermediaries in performance reports, improve its methodology documentation, and enhance oversight of controls over monitoring of improper payments.

HUD has increased its focus on the electronic monitoring of its intermediaries. In the past, HUD has performed comprehensive onsite monitoring reviews to increase detection of intermediaries’ lack of compliance or errors in complying with the program regulations. We noted that HUD did not prepare its required fiscal year 2010 management plan. As a result, at the headquarters level, HUD did not develop formal plans to establish performance and onsite comprehensive monitoring review goals. The lack of management plans hampered efforts to track and provide oversight of the field offices that are responsible for developing risk assessments and determining which PHAs to review.

Administering programs directed toward victims of natural disasters. In efforts to reduce the physical, human, and economic toll of future disasters, HUD is encouraging States to undertake activities and long-term strategies that focus on reducing damages from future natural disasters. To accomplish this goal, HUD has awarded $312 million in Disaster Recovery Enhancement Fund (DREF) monies to support the long-term recovery following dozens of natural disasters in 2008. Since these States previously received Community Development Block Grant funds for disasters, 13 States were eligible to receive the DREF funds to target disaster mitigation.

Over the past several years, HUD has allocated more than $29.4 billion to various States through its Community Development Block Grant program. These active disaster grants nationwide have $23 billion in obligations and $18 billion in disbursements. Regarding the $19.6 billion in funds provided to Gulf Coast States for Hurricane Katrina, $15 billion or 76.3 percent of the funds had been disbursed through September 30, 2010.

As Gulf Coast communities work to recover from Hurricane Katrina, other communities throughout the United States are feeling the effects of natural disasters as well. In addition to the DREF funds, Congress appropriated $100 million to assist the communities affected by the disasters that occurred in the spring of 2010. Supplemental appropriations were enacted on July 29, 2010, to provide additional funds for disaster relief; long-term recovery; and restoration of infrastructure, housing, and economic revitalization in areas affected by severe storms and flooding from March through May 2010 for which the President declared a major disaster.

As a result of its continuing role in addressing natural disasters, HUD faces significant management challenges as identified by our 2010 audit work. In a recent audit, we reported that more than $18.7 million in questioned costs was incurred because one State did not follow Federal and State requirements. The State was not ready to handle the many differences in contracting with disaster funds and was thereby ill-prepared to meet the challenges created by the natural disaster. In efforts to reduce the physical, human, and economic toll of future disasters, HUD has a unique challenge of encouraging States to undertake long-term strategies that focus on mitigating the impact of future natural disasters. The challenge for HUD is to facilitate disaster preparedness by improving the long-term recovery process and ensuring that a comprehensive community development plan is in place.

Further, HUD will have continuing challenges in preventing duplication of benefits from the many Federal disaster programs, along with balancing timeliness of fund distribution versus the need for accountability and controls in disaster programs.