



**U.S. Department of Housing and Urban
Development**

**Multifamily Bond Refunding
Washington, DC**



Issue Date: March 14, 2014

Audit Report Number: 2014-AT-0001

TO: Benjamin Metcalf, Deputy Assistant Secretary, Multifamily Housing, HT
Mark VanKirk, Director, Office of Asset Management, HTG

FROM: Nikita N. Irons, Regional Inspector General for Audit, Atlanta Region, 4AGA

SUBJECT: Violations Increased the Cost of Housing's Administration of Its Bond Refund Program

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of the Office of Multifamily Housing Programs' implementation and management of its McKinney Act bond refund program.

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

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

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



March 14, 2014

Violations Increased the Cost of Housing's Administration of Its Bond Refund Program

Highlights

Audit Report 2014-AT-0001

What We Audited and Why

We audited certain portions of the U.S. Department of Housing and Urban Development's (HUD) multifamily housing programs as part of our fiscal year 2013 annual audit plan, based on an auditability study that we conducted, which identified potentially significant risk factors in its McKinney Act bond refund program. The objectives of the audit were to determine whether HUD properly enforced requirements that regulated the application of automatic adjustment factors to Section 8 rents for projects that had bond refund savings to prevent excessive rents and whether adjustments to receivables due to HUD from bond refunds were properly supported.

What We Recommend

We recommend that the Deputy Assistant Secretary for Multifamily Housing develop and implement procedures for (1) monitoring the calculation of annual rent increases for Section 8 projects and the remittance of trust fund balances; and (2) ensuring requests made by Housing for adjustments to bond receivables are in accordance with requirements. In addition, we recommend that the Deputy Assistant Secretary initiate actions needed to ensure the enforcement of program requirements and the proper resolution of more than \$2.7 million in questioned costs.

What We Found

There were violations relative to HUD's calculation of rents using automatic annual adjustment factors for bond-refunded projects and justification and support for writeoffs of receivables due to HUD from bond refunds. Specifically, HUD paid more than \$2.6 million in excessive Section 8 rents due to a pattern of violations, which would indicate the existence of excess rents beyond the projects reviewed during the audit and similar to violations reported in past reviews (see Background and Objectives section). More than \$2.7 million in questionable writeoffs of receivables due to HUD for bond refund savings were also identified. The amount included more than \$2.6 million, which HUD wrote off without proper justification, and more than \$139,000 for which HUD could not locate or provide proper documentation to show whether the writeoff was justified and supported. We also identified the release of more than \$143,300 in trust fund balances to entities outside HUD without proper support. These conditions occurred primarily because the Office of Housing had not developed and implemented adequate monitoring of the bond refund program to ensure compliance with requirements.

TABLE OF CONTENTS

Background and Objectives	3
Results of Audit	
Finding: Violations Increased the Cost of Housing’s Administration of Its Bond Refund Program	5
Scope and Methodology	14
Internal Controls	16
Appendixes	
A. Schedule of Questioned Costs and Funds To Be Put to Better Use	18
B. Auditee Comments and OIG’s Evaluation	19
C. Schedule of Projects With Excessive Section 8 Rents	25
D. Schedule of Questionable Writeoffs of HUD Receivables	26

BACKGROUND AND OBJECTIVES

The U.S. Department of Housing and Urban Development's (HUD) Office of Multifamily Housing Programs (Housing) was responsible for implementing and monitoring HUD's multifamily bond refund program. Under the Stewart B. McKinney Homeless Assistance Act and 1992 amendments to Section 1012 of the Act, 50 percent of bond refund savings are due to HUD for financing adjustment factor¹ (FAF) projects and non-FAF projects that entered into a housing assistance payments contract from 1979 to 1984. Also, 24 CFR (Code of Federal Regulations) 811.110(d)(1) provides that HUD approval of a Section 8 refunding proposal requires evaluation by HUD's Office of Multifamily Housing Programs. Since 1989, Housing has been refunding the existing bonds for projects with new construction or substantial rehabilitation subject to the McKinney Act. When McKinney Act bond refunds occur for FAF projects, HUD and the bond issuer² enter into a refunding agreement. The trustee³ splits any bond savings resulting from lower interest rates equally between the bond issuer and HUD. The issuer's portion of the savings must be used to provide affordable housing for households with very low incomes, and the trustee sends HUD its portion of the savings, a process known as a trustee sweep. HUD then sends the savings to the U.S. Treasury. The savings amounts are typically paid in installments until the project's housing assistance payments contract expires or the bonds are paid in full.

The HUD Office of Inspector General (OIG) and the U.S. Government Accountability Office (GAO) issued previous audits, which showed that annual adjustment factor⁴ rents for Section 8 bond-refunded projects were excessive or were not always calculated in accordance with requirements. In 1992, HUD OIG issued an audit report,⁵ which initially determined that HUD was paying excessive rents for Section 8 bond-refunded projects. To fix the problem, OIG recommended that HUD require the backing out of refund savings before applying the adjustment factor to calculate the new rent amounts. HUD initially disagreed with the recommendation and maintained that it did not have the authority to limit Section 8 rent increases. HUD requested a legal opinion from the Office of General Counsel with respect to the legality of adopting the OIG recommendations. In May 1993, the Office of General Counsel informed HUD that it had the authority to implement requirements recommended by OIG.⁶ However, after obtaining this legal opinion, HUD did not act in a timely manner to establish and implement the OIG-recommended requirements. As a result, in January 1997, OIG reopened the recommendations. In August 1997, HUD issued Housing Notice 97-49, which, as recommended

¹ FAF was a special financing factor offered by HUD to Section 8 project owners to offset the effects of prevailing high interest rates in or around the early 1980s.

² A bond issuer is the State or local government entity that issues bonds to finance multifamily projects and uses the proceeds of those bonds to make loans to borrowers.

³ The trustee is the entity with legal responsibility under the trust indenture for disposition of the proceeds of a bond issuance and servicing of the debt represented by the obligations.

⁴ Annual adjustment factor is a type of rent adjustment factor determined and published by HUD for use by project owners to calculate increases to Section 8 contract rents for assisted mortgaged properties.

⁵ 93-HQ-119-0004, issued October 1992

⁶ GCH-0070, issued May 4, 1993

by OIG, required contract administrators to back out sweep savings before applying the annual adjustment factor.

In 1999, GAO audited HUD's bond refund program and determined, despite the prior OIG findings and issuance of the related Notice 97-49, that HUD still allowed excessive Section 8 rents⁷. The excessive rents resulted from failures by HUD to enforce the calculation requirements that were established by Notice 97-49 in response to the OIG audit, coupled with HUD's allowing the Notice to expire within 1 year of issuance. GAO also determined that the expired Notice 97-49 was flawed because it did not adequately explain the methodology for implementing the rent calculation procedure for backing out the sweep savings amounts or contain an example of the calculation. The GAO report was issued on July 30, 1999, but it took HUD until December 2003, or more than 4 years, to issue Housing Notice 03-28 to address the GAO concerns. HUD allowed Notices 97-49 and 03-28 to expire in 2007, but the requirements they contained are still enforceable.

By the time of our audit, most of the original FAF Section 8 contracts had been renewed under Section 524 of the Multifamily Assisted Housing Reform and Affordability Act of 1997, and operating cost adjustment factors⁸ were used to adjust Section 8 rents, replacing the annual adjustments factors. The excessive rents calculated using the annual adjustment factors caused subsequent excessive rents based on operating cost adjustment factors.

The objectives of the audit were to determine whether HUD properly enforced requirements that regulated the application of automatic adjustment factors to Section 8 rents for projects that had bond refunds to prevent excessive rents and whether adjustments to the bond receivables were properly supported.

⁷ GAO/RCED-99-217, issued July 1999

⁸ Operating cost adjustment factors were a type of rent adjustment factors determined and published by HUD for use by project owners to calculate increases to Section 8 contract rents for assisted mortgaged properties.

RESULTS OF AUDIT

Finding: Violations Increased the Cost of Housing's Administration of Its Bond Refund Program

We identified violations concerning the incorrect calculation of rents by HUD's contract administrators' using automatic annual adjustment factors, and inadequate HUD justifications and support for writeoffs of receivables due to HUD from bond refunds. These conditions occurred primarily because Housing had not developed and implemented adequate monitoring of the bond refund program's rent calculation and writeoff processes or enforced related requirements. As a result, HUD paid more than \$2.6 million in unnecessary Section 8 subsidy payments due to excessive rent calculations and had more than \$2.7 million in questionable writeoffs of receivables due to HUD for bond refund savings. The writeoffs included more than \$2.6 million, which was not justified, and more than \$139,000 for which HUD could not locate or provide support needed to determine whether the writeoffs were justified and supported. We also identified the release of more than \$143,300 in trust fund balances for FAF 424 to entities outside HUD without proper support. The violations concerning excessive rents were similar to violations identified in past audits by the OIG and GAO.

Requirements for Calculating FAF Section 8 Rent Increases Not Enforced

We identified more than \$2.6 million in excessive Section 8 rents (appendix C) due to HUD's failure to enforce requirements that its contract administrators were to follow when calculating automatic annual adjustment factor increases for bond-refunded projects that involved sweep payments to HUD. The excessive rents represented the difference between the rents that the contract administrators calculated and the rents that should have been used had they followed requirements. HUD Housing Notices 97-49 and 03-28⁹ require contract administrators to back out sweep savings amounts before applying the annual adjustment factors to calculate the rent increases. We selected three contract administrators from a total of 343 contract administrators with bond-refunded projects for the period January 1, 2004, to July 31, 2013. None of the three contract administrators reviewed followed the required calculation method to back out the sweep payments before calculating the rent increases. The excessive rents related to 14 of the 15 projects reviewed. One project did not have rent increases for the review period.

⁹ Both notices had expired, but the requirements are enforceable because they were based on regulatory and statutory requirements that are still applicable.

Contract administrator	Project count	Excess housing assistance payments due to excess Section 8 rents	Projects with violations	Funds to be put to better use
Connecticut Housing Finance Authority	5	\$1,241,861	5	\$107,330
New Jersey Housing Mortgage Finance Agency	4	\$ 858,949	4	\$154,451
Massachusetts Housing Finance Agency	<u>6</u>	<u>\$ 565,844</u>	<u>5</u>	<u>\$ 17,858</u>
Total	<u>15</u>	<u>\$2,666,654</u>	<u>14</u>	<u>\$279,639</u>

The excessive rents caused a corresponding excess in subsidy payments to project owners, which was an unnecessary expense to HUD. These amounts could not be recovered because the contract administrators that made the incorrect calculations worked for and represented HUD. This condition was significant, considering that OIG, GAO, and HUD’s Office of General Counsel had addressed the rent calculation issues as early as 1992, but Housing consistently failed to adequately enforce the requirements (see Background and Objectives section). We estimate that more than \$279,000 in annual funds could be put to better use if the rents for the 14 projects are adjusted to the level reflected by our calculations.

In addition to the sampled projects, representatives for two of the contract administrators (Connecticut and Massachusetts) told us that they did not deduct sweep savings when they calculated annual adjustment factor increases for any of the other 42 bond-refund projects for which they were responsible. This total included 10 additional projects for Connecticut and 32 for Massachusetts. Massachusetts¹⁰ was cited in the 1999 GAO audit for not backing out sweep savings before calculating annual Section 8 rent increases. The representatives for Connecticut and New Jersey contract administrators and officials at the Newark, NJ, field office told us that they were not familiar with the rent calculation requirements for backing out the sweep payments.

If the lack of monitoring persists nationwide, the excessive rents may also apply to the more than 1,000 similar FAF projects nationwide that were not reviewed. We recognize that most Section 8 bond-refunded projects have completed or nearly completed their sweep payments to HUD. More than 77,000 units, with Section 8 contracts will expire between 2014 and 2033 if not renewed.

¹⁰ We included Massachusetts in our sample to determine whether HUD took action to ensure that it corrected the violation cited in the GAO report and found that it had not.

Section 8 contract expiration year	National universe – Section 8 McKinney Act projects	
	Number of projects	Number of units
2014-15 (within 2 years)	164	13,358
2016-20	100	6,251
2021-25	396	28,972
2026-30	147	12,516
2031-33	<u>280</u>	<u>19,207</u>
Subtotal	1,087	80,304
Less: projects reviewed	<u>(15)</u>	<u>(2,555)</u>
Total	<u><u>1,072</u></u>	<u><u>77,749</u></u>

**Unjustified or Unsupported
Negative Adjustments to HUD’s
Bond Receivables**

Housing did not follow or document that it properly followed HUD’s debt collection requirements before writing off more than \$2.6 million in receivables due to HUD for savings derived from bond refunds. We selected and examined 12 negative adjustments or writeoffs to the bond receivables, which totaled more than \$9.9 million (appendix D), from a total of 63 negative adjustments or writeoffs, which totaled more than \$ 21.6 million, during the period October 1, 2005, through January 1, 2013. We identified violations associated with three adjustments totaling more than \$2.7 million, or 27.8 percent of the amount reviewed. HUD Handbook 4350.1, REV-1, Multifamily Asset Management and Project Servicing Handbook, section 1-4 (Responsibility of Housing), requires that the Office of Multifamily Housing Management exercise responsibility toward taxpayers as applicable to its respective programs by maximizing collections of all funds due to HUD and enforcing statutes and regulations. Specifically, the more than \$2.7 million included more than

- **\$2.6 million** for FAF 210 which was prematurely written off as not economically collectable without evidence of proper analysis for a project that had the indicated financial capacity to make some if not all of the delinquent sweep payments. Section 4.03 of the trust indenture required the project to make missed sweep payments when funds became available. In addition, HUD’s Debt Collection Handbook 1900.25, REV-3, section 3-12, provides that when a claim is terminated, the unpaid balance may be written off from HUD’s accounting records.

In this case, the files showed a number of financial and physical condition indicators that the project should have been able to pay all or at least a portion of the \$2.6 million in the delinquent sweep payments that Housing wrote off. For instance, the writeoff was for the period 2003 to 2008, during which the project had annual net income (ranging from \$172,662 to \$458,143) and surplus cash (ranging from \$47,850 to \$93,836) and made

distributions to the owner (ranging from \$47,850 to \$70,843 for 5 of the 6 years). The files also showed that in August 2007, the project had a Real Estate Assessment Center inspection score of 82b,¹¹ coupled with no exigent and fire safety deficiencies other than for smoke detectors.

The file showed that one reason HUD approved the refund was to enable the project to make delinquent sweep payments. However, within 6 months of the approval, Housing requested the writeoff with inadequate evidence to support that determination and no explanation that reconciled the writeoff request with the refunding approval, which was designed in part to restore the project's ability to make the past-due payments. HUD's Debt Collection Handbook 1900.25, REV-3, section 3-12 provides that a writeoff does not mean that the debtor is resolved of his or her obligation to pay and HUD may resume collection of the claim if its collectability can be reestablished within the statute of limitations for debt collection requirements. In addition, the files contained no evidence that the project owner asked Housing to request a writeoff of its sweep payments.

The property owner also displayed a pattern of attempts to avoid making sweep payments even after the 2008 re-refunding and writeoff. For instance, the file contained copies of 2009 and 2010 emails from the owner to HUD in which the owner asserted that the project was to make savings payments to the U.S. Treasury only if projections in the sweep schedule held true. At the time, however, a HUD official noted that the project was not affected by the stressed economy and had a 3-month waiting list. Therefore, HUD did not write off the amounts.

- **\$139,000 for two writeoffs** for FAFs 393 and 184, which were not properly supported. We examined the files provided by Housing for the writeoffs, which did not contain evidence that the writeoffs were justified and supported.

We attribute the above violations to Housing's lack of monitoring. As of September 30, 2013, HUD still had more than \$17.1 million in outstanding bond receivables, which were subject to writeoffs or adjustments. The receivable balance was large enough to warrant continued oversight to ensure that any further writeoffs were justified and supported.

¹¹ Scores can range from 0 to 100, and a passing score is 60 or above. The lowercase letter "b" is given if there are one or more non-life-threatening health and safety deficiencies, but no exigent or fire safety health and safety deficiencies were observed other than for smoke detectors.

Improper Release of Balance in Bond Trust Account

HUD's Newark field office allowed Church Street Corporation and the Borough of Keansburg Housing Authority to keep more than \$143,300 in trust fund balances for FAF 424 without supporting that conditions imposed by HUD headquarters for them to do so were met. Specifically, section 4.16 of the Corporation's trust indenture provides that upon final payment of the principal or the redemption price of and interest on the bonds and other fees, charges, and expenses, all amounts remaining in all funds and accounts should be paid to HUD. However, HUD headquarters issued a revised bond redemption proposal memorandum allowing the Corporation to keep the balances in its trust accounts if

- It used the remaining savings in accordance with the quality requirements of the McKinney Act.
- It provided the annual certifications report and an independent audit validation report required by Section 9 of its refunding agreement.
- HUD's Newark program center provided documentation showing that it entered into a memorandum of understanding with the Authority that required the Authority to commit any funds received from the bond redemption to affordable housing activities in the Borough of Keansburg.

However, in May 2009, HUD's Newark field office released HUD's right to collect the more than \$143,300 in trust balances without adequate support that HUD headquarters conditions had been met. Specifically, the Newark field office signed a document, which released HUD, the Corporation, and the Authority from any future claim arising against each other in connection with the transaction. The release may now prevent HUD from making a claim for the funds if the conditions that allowed the Corporation and the Authority to keep the funds were not met. The funds consisted of the following amounts:

Trust account	Transfer to the Corporation	Transfer to the Authority	Total
Bond reserve fund	\$ 1,581	\$ 1,581	\$ 3,162
Tax and utility reserve fund	\$45,106	\$45,106	\$ 90,212
FAF escrow account	\$26,837	\$0	\$ 26,837
Tax utility and general insurance escrow and replacement escrow	\$ 2,569	\$ 2,569	\$ 5,138
Rental escrow account and operating escrow account	\$18,020	\$0	\$ 18,020
Total	\$94,113	\$49,256	\$143,369

HUD headquarters Housing officials told us they were aware of this condition, which occurred because the Newark field office closed the transaction without implementing and documenting completion of the conditions that headquarters imposed on the transaction.

Inadequate Monitoring of Certain Components of the Bond Refund Program

Housing did not have adequate monitoring in place over its bond refund program. HUD had not developed and implemented comprehensive and adequate risk-based monitoring procedures and controls to ensure that contract administrators accurately calculated rents for bond-refunded projects that involved sweep savings payments due to HUD and that requests to write off sweep payments due to HUD were properly assessed, supported, and approved before submitting them to the claims collection officer. HUD Handbook 1840.1, Departmental Management Control Program, paragraph 1-3(D)(4), provides that the Assistant Secretary for Housing is responsible for implementing management control requirements for Housing. Office of Management and Budget Circular A-123, section IV, requires managers to continuously monitor and assess the effectiveness of management controls for their programs.

The inadequate monitoring deprived Housing of information that should have resulted in its detection and timely correction of what turned into a pattern of violations by contract administrators in the calculation of excessive rent increases for bond-refunded projects and lack of justification and support for the writeoff of millions in sweep savings payments due to HUD. Our assessment of HUD's monitoring revealed the following conditions:

- **Section 8 rent increases** - HUD's monitoring of its contract administrators did not consider whether they backed out trustee sweep payments before using annual adjustment factors to calculate new Section 8 rents for projects that involved sweep savings payments due to HUD from bond refunds. Housing's monitoring review checklist for contract administrators included a section that addressed processing rent adjustments, but it did not specifically address backing out trustee sweep payments. When questioned about this, a HUD official explained that it was not a part of the contract administrators' responsibilities. However, Housing Notices 97-49 and 03-28 held contract administrators responsible for making the rent calculations.

The inadequate monitoring resulted in missed opportunities by HUD to identify and to correct violations of its rent calculation requirements, which resulted in excessive Section 8 rents, causing millions in excessive subsidy payments by HUD to project owners. This condition was significant considering that a 1992 OIG audit initially identified problems with the

calculations and the matter was reiterated in a 1999 GAO audit (see Background and Objectives section). Despite these audits, we identified rent calculation problems throughout the 2004 to 2013 period covered by the audit. Housing had not developed or provided us with documentation to support that it had developed and implemented effective procedures to monitor and enforce the rent calculation requirements for bond-refunded projects. HUD's ability to retroactively recover the excessive subsidies is questionable because it should have been aware of the problem and did little to stop the violations and the excessive calculations were made by contract administrators that worked for and represented HUD.

- **Negative adjustments (some were writeoffs) to HUD receivables for bond savings** - Housing could not demonstrate adequate monitoring and procedures to ensure the reasonableness, justification, support, and proper approvals of requests made by Housing officials to the departmental claims officers to write off or reduce receivable accounts for sweep savings payments due to HUD. The controls and oversight were needed and may have reduced or prevented instances of the type detected, of which adjustments or writeoffs totaling more than \$2.7 million were not justified and were inadequately supported.
- **Bond trust account balances remitted to HUD** - Housing did not monitor bond trustees to determine whether they properly remitted to HUD all debt service reserve balances that remained after the bonds were paid in full. A HUD official stated that Housing did not monitor this area because it relied on trustees to make the required payments based on the terms stated in trust indentures for the respective projects. We visited four issuers and reviewed their records after bond payoff. In each case, the debt service reserve funds were disbursed appropriately.

However, we identified one instance in which a HUD field office did not document compliance with conditions set by HUD headquarters on the release of funds which were otherwise payable to HUD. As a result, the HUD field office allowed the issuer and another entity to keep more than \$143,300 in bond trust account balances (not the debt service reserves) without support that they met the conditions set by Headquarters to allow the payments.

Conclusion

Housing needs to develop and implement controls and procedures, including monitoring, to ensure compliance with program requirements for calculating annual Section 8 rent increases for bond-refunded projects and for the writeoff of receivables due to HUD from these types of projects. We identified violations of the rent calculation requirements, which resulted in more than \$2.6 million in excessive rent and related HUD subsidies. The violations for the small sample,

coupled with the historical nature of the violation (see the Background and Objectives section), indicate similar violations of the calculation requirements involving potentially millions in additional excess rents and subsidy payments from an undetermined portion of the more than 1,000 projects (consisting of more than 77,000 units) not reviewed. The audit also revealed more than \$2.7 million in writeoffs to HUD's bond receivables that were either not justified or not properly supported. As of September 30, 2013, HUD had more than \$17.1 million in outstanding bond receivables. This balance was large enough to warrant continued oversight of writeoffs. In addition, we identified more than \$143,300 in bond funds that were due to HUD, which a field office improperly released to other parties without ensuring that conditions set by HUD headquarters were met to allow it to relinquish HUD's rights to the funds. We attribute these violations to a lack of proper management oversight by Housing of the bond refund program and a failure by Housing, field offices, and contract administrators to follow requirements.

Recommendations

We recommend that the Deputy Assistant Secretary for Multifamily

- 1A. Develop and implement controls and procedures to monitor the application of required rent adjustments to Section 8 FAF projects which should include adding a section to Housing's monitoring review checklist to address the backing out of trustee sweep payments.
- 1B. Require contract administrators that did not apply the back-out requirements to recalculate all FAF projects with Section 8 rent increases that occurred from January 2004 to the present and adjust current and future rents to the amounts supported by the calculations. We estimate annual savings of \$279,639 through the implementation of this recommendation for the projects reviewed.
- 1C. Renew Housing Notices 97-49 and 3-28 and include appropriate example calculations to guide contract administrators and HUD staff on how to calculate annual adjustment factor rents for bond-refunded projects and for use in enforcing the requirements.
- 1D. Develop and implement controls to ensure requests made by Housing for adjustments to bond receivables are properly assessed and supported in accordance with provisions in Housing Notice 3-28.
- 1E. Reassess the \$2,621,624 unjustified writeoff for FAF 210 and reinstate and pursue collection of all or any portion of the amount determined to have been written off without proper justification.

- 1F. Reassess the \$72,969 unsupported writeoff for FAF 393 and reinstate and pursue collection of all or any portion of the amount determined to have been written off without proper justification.
- 1G. Reassess the \$67,000 unsupported writeoff for FAF 184 and reinstate and pursue collection of all or any portion of the amount determined to have been written off without proper justification.
- 1H. Develop and implement controls and procedures to monitor the remitting of trust fund balances to ensure that funds due to HUD upon prepayments or normal payoff of bonds are not released to other parties unless conditions established by headquarters are met and documented.

SCOPE AND METHODOLOGY

We performed the audit from April to December 2013 at HUD headquarters in Washington, DC, and OIG offices in Atlanta, GA, and Jacksonville, FL. The audit generally covered the period January 1, 2004, through July 31, 2013. We adjusted the period when necessary.

To accomplish our objectives, we

- Researched HUD handbooks, Housing notices, the McKinney Act, and other requirements that govern the bond refund program.
- Assessed the results of a 1992 HUD OIG audit and a 1999 GAO audit of the bond refund program for issues that were relevant to our audit objectives and to determine whether HUD had taken timely and adequate action to address the concerns raised by those audits.
- Selected bond-refunded projects for review to determine whether they complied with HUD's Section 8 rent calculation requirements. The sample included three contract administrators with 15 of the largest projects with large bond receivable balances due to HUD from a universe of 343 contract administrators and 754 projects, which included all FAF bond-refunded projects with a bond savings receivable balance due to HUD as of fiscal year 2004. We assessed calculations for the period January 1, 2004, through July 31, 2013.
- Selected 12 of the largest negative adjustments to HUD's bond receivables, which totaled more than \$9.9 million, from a universe of 63 adjustments totaling more than \$21.6 million to determine whether the adjustments were properly supported. The sample included adjustments that were made for the period October 1, 2005, through January 1, 2013.
- Selected debt service reserves for review to determine whether the funds remaining after bond payoff went to HUD as required. The sample included seven of the largest projects with large bond receivable balances due to HUD from a universe of 167 projects, which included projects that had been paid off or had their Section 8 contracts expire between October 1, 2009, and May 31, 2013.

We identified excessive rents of \$279,639 shown as funds to be put to better use. This is the difference between the excessive rents charged (\$27,296,520) and the rents that should have been charged (\$27,002,905) if the rents had been calculated correctly, less \$13,976 for vacancies. Thus, the funds to be put to better use calculation was $\$27,296,520 - \$27,002,905 - \$13,976 = \$279,639$. We calculated vacancies based on the projects 3 year average vacancy rates.

We did not review and assess general and application controls for computer-processed data that HUD entered into its information system. We conducted other tests and procedures to ensure the integrity of computer-processed data that were relevant to our

objectives. The tests included reviewing Housing's files to determine which projects were bond refunded projects with sweep savings due to HUD and the justification for writeoffs of receivables due to HUD. The testing of data revealed that the reliability of the data was adequate for our purposes.

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

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 objectives:

- Program operations - Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Compliance with laws and regulations - Policies and procedures that management has implemented to provide reasonable assurance that program implementation is in accordance with laws, regulations, and provisions of contracts or grant agreements.

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.

Significant Deficiency

Based on our review, we believe that the following item is a significant deficiency:

- Housing did not have adequate controls in place to ensure (1) accurate annual automatic adjustment factor rents for Section 8 projects that involve sweep

payments to HUD and (2) proper justification and support for writeoffs of sweep payments due to HUD.

APPENDIXES

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Unsupported 1/	Unreasonable or unnecessary 2/	Funds to be put to better use 3/
1B.			\$279,639
1E.		\$2,621,624	
1F.	\$72,969		
1G.	\$67,000		



- 1/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.
- 2/ Unreasonable or unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.
- 3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. In this instance, the \$279,639 represents the Section 8 subsidy that would not be paid out over the next year if HUD increases its controls and ensures the proper rents are approved on projects with bond savings. Once HUD improves its controls these savings will recur. Our estimate only includes the initial year of this benefit.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation

Auditee Comments

	<p>U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT WASHINGTON, DC 20410-8000</p>
OFFICE OF HOUSING	FEB 11 2014
MEMORANDUM FOR:	Nikita N. Irons, Regional Inspector General for Audit, Atlanta Region, 4AGA
FROM:	 Mark B. Van Kirk, Director, Office of Asset Management, HTG
SUBJECT:	Draft Audit Report – Housing’s Administration of Its Bond Refund Program

This memorandum provides comments on the subject draft report. Because the final audit report, once issued, becomes a public document, and our response to recommendations will be dealing with some internal control issues, we will communicate separately our specific plans in the proposed management decision following issuance of the final audit report. Thank you for the opportunity to comment on the draft audit report. The goal of our comments is to enhance our use of your audit work.

General Observation

The original objective of the audit survey per the Announcement Letter issued April, 2013, stated that the survey was, "...to determine whether HUD received its share of bond refund savings as required under the McKinney Act." In the draft report you changed this to state that, "The objectives of the audit were to determine whether HUD properly enforced requirements that regulated the application of automatic adjustment factors to Section 8 rents for projects that had bond refund savings to prevent excessive rents and whether adjustments to receivables due to HUD from bond refunds were properly supported." During the audit, you reviewed most of our files for this program and did not report on the results relative to the original objective.

Loss Findings Disproportionate to Total Savings

The caption and Subject reference, "Significant Violations Increased the Cost of Housing’s Administration of Its Bond Refund Program" misrepresents the program performance as tested by your review of our files to properly put the program results in context. Over the course of the program, a total of \$1.1 billion in trustee sweeps will be returned to the Treasury, and \$850 million to participating state/local agencies to be used for housing for very low income families (not including savings in rent reductions from those transactions which did not use trustee sweeps).

Meanwhile, only one transaction was identified as having funds lost due to a writeoff. The refunding of Audubon Pointe in Arkansas identified a loss of \$2.6 million. The loss is

www.hud.gov espanol.hud.gov

Comment 1

Comment 2

approximately .0002% of the \$1.1 billion returned to the Treasury through 656 transactions covering over 900 Section 8 projects.

Audubon Pointe not Legally Bound to Sweep Schedules

Comment 3

Concerning Audubon Pointe, the partial write-down of savings in the 2008 refunding was approved as part of a comprehensive response to financial difficulties resulting from a 1997 Section 8 rent freeze in the non-FHA financed inventory. The track record of the Audubon ownership and the repair needs of this property (in service since 1981) were fully vetted by the Little Rock Multifamily Director who considered these 200 units of housing for the elderly, a significant resource for the market area. As part of the 2008 transaction, the owner agreed to extend affordability restrictions for 10 years beyond HAP expiration. Due to the thin operating margin in Audubon, the annual savings installments were relatively small for this size project. As a result, the savings are significantly back-loaded by committing all of the debt service balance to HUD at bond maturity (it provides 52% of total savings in the 2008 sweep schedule), in a transaction which is not subject to the requirements under 24 CFR Part 811, to remit final reserves to HUD. In evaluating this and the entire trustee sweep bond refunding, the OIG should keep in mind that the projects are subject to no binding legal commitments to the sweep schedules put in place at bond closing. There is no equivalent here to owners executing mortgage modifications and HAP rent reductions as would occur in mortgage refinancing.

Response to Recommendations

The following comments respond to the recommendations listed in pages 12-13 of the draft report. We are suggesting they be revised as needed:

Comment 4

- Recommendation 1B is unclear on whether what it is asking HUD to do through the contract administrators is enforceable. An adjustment of current and future rents based on calculations of what rents should have been if trustee sweeps had been backed out in applying Annual Adjustment Factors (AAF) factors has to be subject to this consideration. Therefore, we suggest that the recommendation be rewritten to state that HUD will prepare these recalculations for the projects your audit reviewed and establish an approved rent that the contract administrators can implement to the extent enforceable.

Comment 5

- Recommendation 1C asks us to renew Housing Notices 97-49 and 03-28. Footnote 9 on page 5 notes these are enforceable based on statutory and regulatory requirements that are still applicable.¹ Also, you state in this recommendation that guidance for calculating the AAF used by contract administrators should be included supported by appropriate examples. Conduct by contract administrators is controlled by their business agreements. We suggest this recommendation be revised to keep the scope of an appropriately issued Housing Notice separate from any contract requirement.

¹ It should be noted that in April 2012, it became official policy when issuing Housing Notices that they remain in effect until suspended which formalizes the following of statutory and regulatory requirements such as in the example cited.

Comment 6

- Recommendation 1D calls for monitoring of requests for adjustments to trustee sweep receivables that would originate from the Office of Multifamily Housing Programs (MFH). Since MFH originates the request for an adjustment which the Office of the Chief Financial Officer (OCFO) processes, monitoring of a submitted request should be performed by the OCFO. Please clarify the intent of this recommendation.

Comment 7

- Recommendations 1E, 1F, and 1G deal with write-offs of amounts and start with the phrase reassess. We do not think the reversal of these write-offs is enforceable or advisable for the following reasons:
 - \$2,621,624 for FAF 140. This will be impossible considering that the Office of Asset Management (OAM) was in no position to request a write off, having never been informed of the transactions which terminated these future sweep collections. The projects were part of the Pennsylvania State Housing Finance Agency portfolio for which a FAF refunding was done in 1991. Four projects were restructured in OAHF, two were foreclosed, and one was a mortgage prepayment which terminated sweeps with approval of the SHA but without notice to OAM. The OAHF transactions which reduce HAP rents to market constitute a significant and cost effective initiative and these projects had already paid 12 to 15 years of FAF savings installments.
 - \$72,969 for FAF 393. The OAM file contains email exchanges between the bond trustee and the CFO staff which collect and accounts for savings. These continued until 2008 and appear to reflect disagreement about the amount due. The OAM was not advised of the write-off and in any case would have deferred to the CFO on the collectability issue.
 - \$67,000 for FAF 184. This was a transaction which closed in 1991 with savings over the HAP contract term amounting to \$1,226,000 at the final installment on February 1, 2003. Pursuit of this amount eleven years after the fact and after expiration of the HAP contract is not in HUD's best interest.

Comment 8**Comment 9**

- Recommendation 1H calls for controls to monitor the remitting of final bond reserve balances to HUD upon bond redemption. We question the relevance of this problem, since it is not a function of the bond refunding program. State Agency bonds are not usually issued under 24 CFR Part 811 and the Section 11(b) requirement for rebate of final balances to HUD. Nor are those local agency "old regulation" Section 11(b) bond issues. This subject was addressed by OIG in Audit report number 2007-KC-0003. Housing has responded in a proposed rule FR-5583-P-01 published for comment last year. A revised final rule should be ready for clearance this spring. Consequently, we request that this recommendation be eliminated or deferred pending the implementation of the proposed rule.

Thank you for raising these issues and the opportunity to respond to your draft audit report. Our specific management plans will be developed once we receive the final audit report. Should you have questions regarding this memorandum, please call Clint Bradley of my staff at (202) 402-8118.

Cc: Benjamin T. Metcalf, Deputy Assistant Secretary for Multifamily Housing Programs
Nancie-Ann Bodell, Director of Program Administration, Office of Deputy Assistant Secretary for Multifamily Housing Programs

OIG Evaluation of Auditee Comments

- Comment 1** HUD noted that the original objective in the survey was different from the final objective during the audit. We emailed HUD officials on July 3, 2013, shortly after the audit phase began to inform them of the areas we planned to focus on during the audit. While we acknowledge that the survey and audit objectives are different, it's not unusual for objectives to change between the survey and audit phase. The survey typically identifies specific areas that need review and we refine the original broad objectives to address those areas accordingly during the audit.
- Comment 2** HUD compared the amount of the violations identified during the audit to the amount of trustee sweeps sent to the Treasury over the entire course of the program which is exceptionally larger than our audit period universe. We revised the report title and finding caption to "Violations Increased the Cost of Housing's Administration of Its Bond Refund Program".
- Comment 3** HUD indicated that the Audubon Pointe project (FAF 210) was fully vetted by the Little Rock Multifamily Director prior to the writeoff. However, our own review of the project's Real Estate Assessment Inspection scores showed that the project was in good physical condition and the project's financial statements showed that for the period 2003 through 2008 included in the writeoff, the project had annual net income (ranging from \$172,662 to \$458,143), surplus cash (ranging from \$47,850 to \$93,836) and made distributions to the owner (ranging from \$47,850 to \$70,843 for 5 of the 6 years). These conditions collectively indicate that the project should have been able to pay all or at least a portion of the \$2.6 million in the delinquent sweep payments that Housing wrote off. Section 4.03 of the trust indenture required the project to make missed sweep payments when funds became available.
- Comment 4** HUD stated that it is unclear whether recommendation 1B is enforceable. To clarify, we are not asking that HUD collect past rents in this recommendation but rather to require contract administrators to recalculate the rents since 2004 and adjust current and future rents accordingly. The recalculation of rents is needed due to the cumulative nature of Section 8 rents for bond refunded projects in which past rent levels affect current and future rent levels. In other words, past overstated rents may result in overstated current and future rents. Additionally, the rent recalculations are necessary to comply with Housing Notices 97-49 and 3-28 which OGC determined was enforceable.
- Comment 5** HUD commented that recommendation 1C is asking for adjustments to Contract Administrator requirements and the renewal of Housing Notices that are still enforceable. While we recognize that the Notices are still enforceable, we believe the renewal is warranted in part to notify Contract Administrators that the Section 8 rent calculation requirements for bond refunded projects are still in effect. The addition of a detailed example to the renewal of the Notices would also clarify the

requirements so that Contract Administrators can calculate Section 8 rents correctly. Adding an example to the notices does not change the responsibilities of the Contract Administrators under their contracts.

Comment 6 HUD noted that the monitoring included in recommendation 1D should be performed by the Office of the Chief Financial Officer and HUD asked for clarification on the recommendation. We revised the recommendation to “Develop and implement controls to ensure that requests made by Housing for writeoffs are properly assessed and supported in accordance with provisions in Housing Notice 3-28.” This Notice provides last resort exceptions such as mortgage default or property condemnation that would justify the termination of savings due to HUD from bond refunds.

Comment 7 HUD commented that they did not think the writeoffs related to recommendations 1E, 1F, and 1G are enforceable or advisable. We disagree because the writeoffs did not have adequate support that they were justified. HUD Debt Collection Handbook 1900.25, REV-3, section 3-12, provides that a writeoff does not mean that the debtor is resolved of the claim if its collectability can be reestablished within the statute of limitations for debt collection requirements. Furthermore, HUD Handbook 4350.1, REV-1, Multifamily Asset Management and Project Servicing Handbook, section 1-4, requires that the Office of Multifamily Housing Management exercise responsibility toward taxpayers as applicable to its respective programs by maximizing collections of all funds due to HUD and enforcing statutes and regulations. A reassessment by HUD is warranted because more than \$2.7 million in bond receivable writeoffs may be reinstated if collectability can be reestablished.

Comment 8 HUD stated that the final installment for FAF 184 occurred on February 1, 2003, and pursuit of the writeoff 11 years after the fact is not in HUD’s best interest. We disagree because our recommendation is not based on the date the final installment was made but rather the date the writeoff of the bond receivable occurred, which was December 2009 for FAF 184.

Comment 9 HUD commented that another HUD-OIG Audit report (2007-KC-0003-001-A) addressed the subject discussed in recommendation 1H and that a final rule should be ready for clearance this spring. As a result, HUD asked that we eliminate or defer the recommendation pending the implementation of the proposed rule. We are willing to defer the recommendation until the final rule is issued and at that time we will revisit the recommendation in light of the final rule to assess whether further action is needed.

Appendix C

SCHEDULE OF PROJECTS WITH EXCESSIVE SECTION 8 RENTS

Project name by HUD office and contract administrator	FAF number	Excess housing assistance payments due to excess Section 8 rents
HUD office: Hartford		
<u>Contract administrator: Connecticut Housing Finance Authority</u>		
Augustana Homes of Bridgeport	329A	\$ 433,160
Hamilton Park	329D	162,488
Huntington Towers Apartments	329E	228,202
Meridian Towers Apartments	329F	205,951
Naubuc Green Apartments	329G	<u>212,060</u>
Subtotal		<u>\$1,241,861</u>
HUD office: Newark		
<u>Contract administrator: New Jersey Housing Mortgage Finance Agency</u>		
<u>Essex Phoenix Mills</u>	155A	\$ 28,327
<u>Grove Street - Bailey-Holt Towers</u>	155D	473,238
<u>New Community Manor</u>	155B	208,993
<u>Oakwood Plaza</u>	155C	<u>148,391</u>
Subtotal		<u>\$ 858,949</u>
HUD office: Boston		
<u>Contract administrator: Massachusetts Housing Finance Agency</u>		
Kenmore Abbey	284K	\$ 369,587
Wilbraham Commons	284AE	103,888
Gardener Terrace	284H	39,236
Solemar II	284AB	37,488
Chelsea Village	284C	15,645
Joseph's House	236J	n/a
Subtotal		<u>\$ 565,844</u>
Total		<u>\$2,666,654</u>

Appendix D

SCHEDULE OF QUESTIONABLE WRITEOFFS OF HUD RECEIVABLES

FAF number	Amount	Not justified and supported	Not properly supported	Notes
210	\$ 2,621,624	\$ 2,621,624		a
393	\$ 72,969		\$ 72,969	b
184	\$ <u>67,000</u>		\$ <u>67,000</u>	b
Total	\$ <u>2,761,593</u>	\$ <u>2,621,624</u>	\$ <u>139,969</u>	

Notes

- a. The writeoff, which occurred in February 2008, totaled more than \$4.2 million, of which \$2.6 million was not supported and justified. Specifically,
- The project's audited financial statements for 2003 through 2008 showed that the project generated income totaling at least \$172,662 and surplus cash of at least \$47,850 for each year in that period. Further, the project made distributions to the ownership partners that ranged from \$47,850 to \$70,843 during 5 of the 6 years.

Year	Net income	Surplus cash	Owner distributions
2003	\$172,662	\$70,843	\$60,444
2004	\$385,085	\$70,843	\$70,843
2005	\$441,991	\$70,844	\$0
2006	\$400,632	\$47,850	\$70,843
2007	\$458,143	\$70,843	\$47,850
2008	\$250,847	\$93,836	\$70,843

- The trustee records showed that the project made its debt service payments during the period 2003 to 2007, although the corresponding sweep payments were written off. Additionally, information in the financial statements conflicted with the project owner's contention in 2007 that operating expenses continued to increase each year. Operating expenses declined from 2006 to 2008.
- HUD approved refunding of the Series 1991 bonds on August 1, 2007, to allow for rehabilitation and to restore the payment of trustee sweep housing assistance payment savings and partially cure a substantial delinquency in

collections of the delinquent amount. At that time, the only delinquent sweep payments were the ones that HUD asked to write off in its January 30, 2008, memorandum to the departmental claims officer. The files contained no evidence that HUD performed and documented an objective assessment of the project's financial condition before it made the writeoff request. HUD made the request within 6 months after approving the refunding, which was intended in part to restore the project's ability to pay the delinquent sweep payments.

- HUD staff indicated that another reason for the writeoff was so that the bond savings could go back into the project to fund extensive repairs and replacements that project reserves could not totally finance. HUD Housing Notice 3-28, paragraph A(1)(a), provides that in cases of imminent mortgage default or physical deterioration threatening the health and safety of residents, cancelation of remaining sweep payments may be considered as a last resort and that HUD's evaluation would take into account Real Estate Assessment Center and Financial Assessment Subsystem scores. The Real Estate Inspection Center inspection results indicated that neither of these conditions was present.

In support of the needed repairs, the files contained a copy of the owner's 2007 budget proposal for more than \$1.5 million, which consisted of more than \$1.1 million for repairs, \$75,000 for working capital, and \$406,000 to be deposited into the reserve for replacement fund. However, the project was not in danger of imminent mortgage default, and most of the repairs were not associated with physical deterioration that threatened the health and safety of residents. For instance, HUD's August 2007 Real Estate Assessment Center physical inspection report gave the project a physical inspection score of 82b. The report cited one or more non-life-threatening health and safety deficiencies and no exigent and fire safety deficiencies other than for smoke detectors. Therefore, the listed repairs were not a supported basis for cancelation of remaining sweep payments based on HUD's last resort provision cited in Notice 03-28.

- The writeoff was excessive even if the above repairs had met the last resort criteria, which they did not, and if they had been paid by the project, which they were not. Specifically, the rehabilitation proposal would have been sufficient only to provide possible support for writing off \$1.1 million of the \$2.6 million writeoff with a balance of \$1.5 million, which still would be unjustified. However, the trust indenture showed that the project received more than \$1.1 million from the 2008 bond re-refund to pay project costs including construction, reconstruction, equipment, and installation. This condition further supports our determination that HUD's decision to write off the \$ 2.6 million in delinquent sweep payments was not justified or supported.

- b. The files maintained by Housing did not contain appropriate documentation needed to show that the writeoff was justified and supported.