



**Michigan State Housing Development Authority  
Lansing, MI**

**Multifamily Project-Based Section 8 Program**



Issue Date: September 30, 2013

Audit Report Number: 2013-CH-1011

TO: Barbara Chiapella, Director of Multifamily Housing Hub, 5FHMLA

//signed//

FROM: Kelly Anderson, Regional Inspector General for Audit, 5AGA

SUBJECT: The Michigan State Housing Development Authority, Lansing, MI, Did Not Follow HUD's Requirements Regarding the Administration of Its Program

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final audit report of our audit of the Michigan State Housing Development Authority's multifamily project-based Section 8 program for new-regulation projects.

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 (312) 353-7832.



September 30, 2013

## **The Michigan State Housing Development Authority, Lansing, MI, Did Not Follow HUD's Requirements Regarding the Administration of Its Program**

# Highlights

Audit Report 2013-CH-1011

### **What We Audited and Why**

We audited the Michigan State Housing Development Authority's multifamily project-based Section 8 program for new-regulation projects as part of the activities in our fiscal year 2013 annual audit plan. We selected the Authority based on a referral from U.S. Department of Housing and Urban Development (HUD) management. Our objective was to determine whether the Authority administered its program in accordance with HUD's requirements.

### **What We Recommend**

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs require the Authority to (1) ensure that program residual receipts of nearly \$31.6 million are used instead of seeking unnecessary housing subsidies; (2) reimburse HUD and the U.S. Treasury more than \$1.2 million for the projects with terminated program contracts; (3) reimburse its project's escrow accounts more than \$465,000 for the inappropriate disbursements of replacement reserves; and (4) implement adequate controls to address the findings cited in this audit report.

### **What We Found**

The Authority did not comply with HUD's requirements regarding the administration of its multifamily project-based Section 8 program for new-regulation projects. Specifically, it failed to use program residual receipts to reduce or offset housing assistance payments for new-regulation projects. As a result, nearly \$31.6 million in unused or excess project funds was not available for HUD to offset future subsidy expenditures.

The Authority did not remit unused or excess funds upon termination of the housing assistance payments contracts for three new-regulation projects. As a result, more than \$1.2 million in unused or excess project funds was not available for HUD to achieve program savings.

The Authority inappropriately disbursed replacement reserves for four projects. As a result, more than \$290,000 was not available to benefit its multifamily projects. Further, its projects lost more than \$175,000 in interest income.

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## BACKGROUND AND OBJECTIVE

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The Michigan State Housing Development Authority was established in 1966 under the laws of the State of Michigan to provide decent, safe, and sanitary housing. The Authority is governed by an eight-member board consisting of the State's treasurer, the director of the State's Department of Human Services, and the director of the State's Department of Transportation. The board includes five other members appointed to 4-year terms by the State's governor and confirmed by the State senate. The board's responsibilities include overseeing the administration of the Authority and approving policies. The board appoints the Authority's executive director. The executive director is responsible for ensuring that policies are followed and providing oversight of the Authority's programs.

The Authority is the housing finance agency for the State of Michigan, acting as the contract administrator for 541 properties. The Authority administered 402 contracts as performance-based contract administrator and 139 contracts as traditional contract administrator. As the contract administrator, the Authority acts under an annual contributions contract with the U.S. Department of Housing and Urban Development (HUD) to administer Section 8 funding to assisted project owners to ensure that Section 8 subsidies fund only necessary and reasonable project operating expenses and otherwise comply with applicable program requirements.

Under its traditional contract administrator portfolio, the Authority administered contracts for 139 projects, of which 41 were subject to the multifamily project-based Section 8 program's new regulations, effective February 29, 1980. Under HUD's Part 883 requirements, the Authority issued mortgage loans for new construction multifamily projects, as a housing finance agency. Generally, mortgages issued in the 1970s and 1980s carried a term of 30 years. As of May 31, 2013, of the 41 new-regulation contracts, 1 contract had been split into 2 new-regulation contracts, and 3 contracts had been terminated. Therefore, 37<sup>1</sup> (41 – 1 – 3) contracts remained current as of May 31, 2013.

During the period January 1, 2010, through December 31, 2012, the Authority received more than \$106 million in housing assistance payments for the new-regulation projects<sup>2</sup> in its housing finance agency and traditional contract administrator portfolio.

The program's new regulations, effective February 29, 1980, require that project funds be used for the benefit of the project, to make mortgage payments, to pay operating expenses, to make required deposits to the replacement reserve, and to provide limited distribution income to the owner. As determined by the Authority, any remaining funds must be deposited with the Authority, other lender, or other Authority-approved depository in an interest-bearing account. This account is generally known as the residual receipt escrow. The Authority, however, refers

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<sup>1</sup> To avoid double counting, we removed the original contract from our count.

<sup>2</sup> HUD identifies projects that entered into housing assistance payments contract, version 8-80 on or after February 29, 1980, as new-regulation projects. For new-regulation projects, HUD requires that excess project funds be used to reduce or offset housing assistance payments. Projects that entered into housing assistance payments contract, version 11-75, or were effective before February 29, 1980 are identified as old-regulation projects. HUD's requirement for the reduction or offsetting of housing assistance payments does not apply to old-regulation projects.

to it as operating reserve cash. In other words, program residual receipts are generated as a result of projects having excess project funds under the program's new regulations. Further, upon termination of the program housing assistance payments contracts, excess project funds must be remitted to HUD.

On August 3, 2012, HUD issued Housing Notice H-2012-14. The notice required that the program residual receipts of new-regulation projects in excess of \$250 per revenue-generating<sup>3</sup> unit be applied monthly to reduce or offset housing assistance payments up to the full amount of the monthly subsidy request, depending upon the amount of residual receipts available. The notice applied to all multifamily project-based Section 8 projects subject to the program's new regulations, which included all of the 41 projects administered by the Authority under its housing finance agency and traditional contract administrator portfolio.

Our objective was to determine whether the Authority administered its program for new-regulation projects in accordance with HUD's requirements. Specifically, we wanted to determine whether the Authority (1) applied program residual receipts to reduce or offset housing assistance payments for new-regulation projects, (2) remitted excess or unused project funds to HUD upon termination of new-regulation contracts, and (3) appropriately maintained escrows for new-regulation projects.

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<sup>3</sup> HUD's clarifications of Housing Notice H-2012-14, dated October 2, 2012, clarified the number of units included in the notice as revenue-generating units.

## RESULTS OF AUDIT

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### Finding 1: The Authority Did Not Use Residual Receipts To Reduce or Offset Housing Assistance Payments

The Authority did not use more than \$31.1 million in residual receipts to reduce or offset housing assistance for new-regulation projects. It also inappropriately disbursed residual receipts totaling nearly \$429,000 to six project owners. These weaknesses occurred because the Authority failed to comply with HUD's requirements due to its lack of understanding of Federal requirements regarding its role in administering the program. As a result, nearly \$31.6 million in unused or excess project funds was not available for HUD to offset future subsidy payments.

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#### **Residual Receipts Were Not Used To Reduce or Offset Housing Assistance Payments**

During the period November 2012 through May 2013, 17 of the 37 new-regulation projects maintained an average balance of more than \$31 million in residual receipts. However, contrary to HUD's requirements,<sup>4</sup> the Authority inappropriately received more than \$4.6 million in housing assistance for the projects instead of using the residual receipts that were available to reduce or offset housing assistance payments (see appendix D).

Further, contrary to HUD's requirements,<sup>5</sup> the Authority inappropriately disbursed \$428,804 of residual receipts, in excess of the required retained balance of \$250 per revenue-generating unit, to six new-regulation projects instead of reducing or offsetting housing assistance (see appendix D). Therefore, had the Authority complied with HUD's requirements, these residual receipts would not have been available for disbursement.

#### **The Authority Lacked an Understanding of Federal Requirements**

The Authority did not apply residual receipts to reduce or offset housing assistance payments for new-regulation projects because it lacked an understanding of HUD's requirements regarding its role as the program

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<sup>4</sup> Housing Notice H-2012-14, section V.C.

<sup>5</sup> Housing Notice H-2012-14, sections V.C. and V.A.

administrator. According to the Authority, HUD's requirements<sup>6</sup> did not apply because the Authority is a housing finance agency. Therefore, in accordance with 24 CFR (Code of Federal Regulations) 883.306(e), the Authority, not HUD, determines whether surplus project funds (residual receipts) may be used to (1) reduce or offset housing assistance payments or (2) for other project purposes.

On October 23, 2012, HUD issued a letter to the Authority regarding its notice. The letter stated that the Authority's interpretation that it had the ability to determine whether funds should be offset lacked merit. Further, the letter stated that while HUD's requirements<sup>7</sup> provided the Authority with some degree of control over the residual receipts account by allowing it to (1) determine that surplus project funds exist, (2) require that such excess funds be deposited in a separate account, and (3) make withdrawals subject to the Authority's approval, both regulatory and contract provisions were clear that these funds must ultimately be remitted to HUD. That is, the funds belong neither to the Authority nor the project owner but, rather, to HUD. HUD acknowledged that neither the regulatory provision nor the corresponding contract provision explicitly state that the determination to use residual receipts to reduce housing assistance payments rests with HUD, as opposed to the Authority.

However, any such determination is by nature a decision that is related to the funding of the rental assistance payments that flow from HUD through the contract to the Authority, as the contract administrator, and ultimately to the owner. Therefore, HUD is entitled to determine that residual receipts must be used to reduce or offset housing assistance payments.

In December 2012, the Authority completed a cash-flow analysis for 15 projects with available residual receipts. According to its analysis, the residual receipts for seven projects should have been used to reduce or offset housing assistance. However, for the remaining nine<sup>8</sup> projects, it projected a cash-flow shortage generally due to an allowance for future owners' limited distribution income. According to HUD's requirements,<sup>9</sup> owner's limited distribution is calculated annually based on project operations after all project expenses and replacement reserves have been paid. Therefore, the Authority could not retain current residual receipts to provide future income to project owners.

As a result of our audit, in June 2013, the Authority revised its cash-flow analysis and schedule of available residual receipts. However, in reviewing the documentation, we determined that the Authority's analysis still contained errors. For example, the revised schedule projected a cash-flow shortage for four projects

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<sup>6</sup> Housing Notice H-2012-14, section V.C.

<sup>7</sup> 24 CFR 883.306(e) and section 2.6(c)(1) of the contract, form HUD-52645A (8-80)

<sup>8</sup> One project is listed on the Authority's analysis as having a cash flow shortage and as having funds available to offset.

<sup>9</sup> 24 CFR (Code of Federal Regulations) 883.306(b)



due to accumulated unpaid owners' income. However, based on our review, only two of the four project owners did not receive income due to a shortage in the projects' cash flows. For the remaining two projects, although the projects had surplus cash, the owners chose not to receive income. According to HUD's regulations,<sup>10</sup> residual receipts may be used to pay unpaid owners' income that resulted from a cash-flow shortage. Therefore, the Authority could not use residual receipts to provide for cumulative unpaid owners' income for these three projects.

In June 2013, although the Authority disagreed with HUD's interpretation of the notice, it began to reduce or offset housing assistance payments for 5 projects, which it determined had surplus project funds. Further, the Authority requested to use the residual receipts of two projects (contract numbers MI33H150039 and MI28H150181) to pay refinancing costs and reestablish the escrow accounts. However, in a letter, dated February 21, 2013, HUD denied the Authority's request to use project funds, including residual receipts, to refinance the Authority-held mortgages because it was not an eligible use of the residual receipts.

## Conclusion

The Authority did not comply with HUD's regulations for reducing or offsetting housing assistance payments because it lacked an understanding of Federal requirements regarding its role in administering the program. The Authority entered into an annual contributions contract with HUD for all new-regulation projects and agreed to all of the contract terms, including the requirement to ensure that all of HUD's requirements would be followed. Therefore, HUD's regulations<sup>11</sup> requiring the reduction or offset of housing assistance payments beginning in November 2012 would be applicable. Based on our review, as of May 31, 2013, 15 of the 17<sup>12</sup> new-regulation projects had program residual receipts totaling more than \$31.1 million available to reduce or offset housing payments. As a result, unused or excess project funds were not available for HUD to offset future subsidy payments.

Appendix D of this report details the program residual receipts available for reduction or offset of housing assistance payments as of May 31, 2013, for the 15 new-regulation projects.

## Recommendations

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<sup>10</sup> 24 CFR 883.306(d)

<sup>11</sup> Housing Notice H-2012-14

<sup>12</sup> During our review, 17 projects had residual receipts balances available for offsetting. However, the Authority released residual receipts for two projects (contract numbers MI28H150202 and MI28H150206); therefore, as of May 31, 2013, only 15 projects had residual receipts available to reduce or offset housing assistance payments.

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs require the Authority to

- 1A. Ensure that \$31,148,477 in residual receipts for the 15 projects as of May 31, 2013, is used to reduce or offset housing assistance payments in accordance with HUD's requirements.
- 1B. Reimburse the appropriate escrow accounts from non-Federal funds \$428,804 in residual receipts, above the required retained balances, disbursed to the six projects, or support that these funds were not required to reduce or offset housing assistance payments.
- 1C. Implement adequate written policies, procedures, and controls to ensure that residual receipts for new-regulation projects are treated in accordance with HUD's requirements. Such procedures and controls should include but not be limited to (1) providing training to its staff and (2) periodically monitoring the projects' residual receipts accounts to ensure that unnecessary housing assistance payments are not received.

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs to

- 1D. Review the Authority's methodology for determining surplus project funds to ensure compliance with HUD's requirements.

## Finding 2: The Authority Did Not Remit Excess Project Funds to HUD

The Authority did not remit unused or excess project funds to HUD for three new-regulation projects with terminated program contracts. This weakness occurred because the Authority (1) lacked adequate procedures and controls and (2) its staff lacked a sufficient understanding of HUD's requirements. As a result, more than \$1.2 million in unused or excess project funds was not available to HUD to achieve program savings. In addition, the Authority's failure to remit unused or excess project funds caused the U.S. Treasury to lose nearly \$13,000 in interest.

### The Authority Did Not Remit Excess Project Funds to HUD

According to HUD's regulations,<sup>13</sup> upon termination of the program contract, any unused or excess project funds must be remitted to HUD. However, based on our review of the three projects, the Authority did not ensure that unused or excess funds totaling more than \$1.2 million were remitted to HUD.

#### Project Funds Transferred to Preservation Fund

For contract number MI28H150160, the project had unused or excess project funds totaling \$114,164 when its program contract terminated on August 31, 2007. The Authority paid project expenses totaling \$35,155, and the project earned \$4,313 in interest between September 2007 and July 2008, thus reducing the amount of excess project funds to \$83,322 ( $\$114,164 - \$35,155 + \$4,313$ ). Instead of remitting the funds to HUD, the Authority inappropriately transferred \$77,830 to its preservation fund<sup>14</sup> and maintained \$5,492 ( $\$83,322 - \$77,830$ ) in the project's residual receipts account. According to a letter from HUD, dated December 11, 2008, the Authority was required to remit all excess project funds to HUD in accordance with its housing assistance payments contract. In November 2010, in response to HUD's request, the Authority remitted residual receipts totaling \$6,465 ( $\$5,492$  from residual receipts +  $\$973$  interest earned), however, the Authority excluded \$26 in interest earned during November 2010. Therefore, as of August 31, 2013, the Authority had failed to remit the project funds totaling \$77,856 ( $\$77,830$  that was transferred to the preservation fund +  $\$26$  that was transferred to the interest account).

#### Project Funds Maintained in Escrow

- For terminated contract numbers MI33H150050 and MI28H150191, the projects had unused or excess funds totaling \$436,759 and \$698,671,

<sup>13</sup> 24 CFR 883.306(e)

<sup>14</sup> An internally created fund that is not associated with the program.

respectively. However, the Authority failed to remit the funds to HUD as required.<sup>15</sup> For example, the project associated with contract number MI28H150191 went into foreclosure in January 2012, and the Authority terminated its program contract on December 31, 2012. However, the Authority had failed to remit \$698,671 (\$604,949 in replacement reserves + \$93,722 in unused or excess funds) in its escrow accounts as of May 31, 2013. According to the Authority, its loan agreement with the owner allowed the replacement reserves to be applied to the defaulted mortgage. However, HUD did not waive the requirement for the Authority to remit unused or excess project funds.

The following table shows the contract numbers, contract termination dates, funds remitted and not remitted to HUD for the three new-regulation projects with terminated program contracts, and lost interest.

Contract number	Contract termination date	Funds remitted to HUD	Funds not remitted to HUD <sup>16</sup>	Amount of interest lost <sup>17</sup>
MI28H150160	August 31, 2007	\$6,465	\$77,856	\$7,774
MI33H150050	February 28, 2013	0	436,759	1,391
MI28H150191	December 31, 2012	0	698,671	3,665
<b>Totals</b>		<u>\$6,465</u>	<u>\$1,213,286</u>	<u>\$12,830</u>

### The Authority Lacked Adequate Procedures and Controls

The Authority did not remit excess or unused project funds to HUD for terminated program contracts because (1) it lacked adequate procedures and controls and (2) its staff lacked a sufficient understanding of HUD’s requirements. For instance, for contract number MI28H150160, the Authority believed that since it had remitted the project’s residual receipts as of November 2010, the funds that were previously transferred to the preservation fund were not required to be remitted to HUD. Additionally the Authority’s loan agreements for new-regulation projects allowed for the absorption of the replacement reserves upon mortgage default. Therefore, the Authority believed that it did not have to remit the funds to HUD for contract number MI28H150191.

### Conclusion

<sup>15</sup> 24 CFR 883.306(e)

<sup>16</sup> As of May 31, 2013

<sup>17</sup> See scope and methodology

The Authority did not remit excess or unused project funds to HUD for terminated program contracts because (1) it lacked adequate procedures and controls and (2) its staff lacked a sufficient understanding of HUD's requirements. As a result, more than \$1.2 million in unused or excess project funds was not available to HUD to achieve program savings. In addition, the Authority's failure to remit unused or excess project funds caused the U.S. Treasury to lose nearly \$13,000 in interest as of May 31, 2013.

## Recommendations

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs require the Authority to

- 2A. Reimburse the U.S. Treasury \$608,337 (\$77,856+ 436,759 + \$93,722) for the three projects with terminated program contracts.
- 2B. Obtain approval from HUD to apply the project's replacement reserves to the defaulted mortgage for contract number MI28H150191 or reimburse the U.S. Treasury \$604,949.
- 2C. Reimburse the U.S. Treasury \$12,830 from non-Federal funds for the lost interest.
- 2D. Implement adequate procedures and controls, including but not limited to providing training to staff, to ensure that unused or excess project funds are remitted to HUD when the contracts for new-regulation projects terminate.
- 2E. Ensure that loan agreements for new-regulation projects comply with HUD's regulations.

## Finding 3: The Authority Inappropriately Disbursed Replacement Reserves

The Authority inappropriately disbursed replacement reserves for project owners' limited distribution income after maturity of the Authority-held mortgages. This condition occurred because the Authority lacked adequate procedures and controls to ensure that it complied with HUD's and its own requirements regarding the maintenance of project funds. As a result, HUD lacked assurance that funds totaling more than \$290,000 were available to benefit the projects, and the projects lost more than \$175,000 in interest.

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### The Authority Inappropriately Disbursed Replacement Reserves

The Authority inappropriately disbursed \$290,437 of replacement reserves<sup>18</sup> for 4 of the 22 (18 percent) projects under program contracts as owners' income or due to changes in ownership. According to HUD's and the Authority's requirements,<sup>19</sup> replacement reserves must be maintained to fund extraordinary maintenance and repair and replace capital items. Further, according to HUD's regulations,<sup>20</sup> upon termination of the program contract, any excess project funds must be remitted to HUD. We reviewed the Authority's capital needs assessments for the four projects and determined that the balance in each project's replacement reserve was not sufficient to meet the Authority's requirements. Therefore, the reserves should not have been disbursed to the projects' owners.

The Authority's noncompliance occurred because it lacked adequate procedures and controls to ensure that it complied with HUD's and its own requirements regarding the maintenance of project funds. The table below identifies the contract numbers, mortgage payoff dates, amount of replacement reserves required by the Authority's capital needs assessment, the balance in replacement reserves that was inappropriately disbursed to owners, and lost interest.

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<sup>18</sup> Replacement reserves are required to be established by the program contract to defray the cost of the replacement of major depreciable items.

<sup>19</sup> 24 CFR 880.602(a) and Authority's reserve for replacement policy revised April 2013.

<sup>20</sup> 24 CFR 883.306(e)

Contract number	Mortgage payoff date	Replacement reserves required	Replacement reserves inappropriately disbursed	Amount of interest lost <sup>21</sup>
MI33H150072	June 19, 2003	\$189,284	\$154,589	\$121,553
MI28H150209	November 30, 2006	494,318	89,427	30,747
MI33H150074	January 18, 2006	158,593	43,917	22,353
MI33H150080	April 1, 2006	177,569	2,504	781
<b>Totals</b>		<u>\$1,019,764</u>	<u>\$290,437</u>	<u>\$175,434</u>

## Recommendations

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs require the Authority to

- 3A. Reimburse \$290,437 to the appropriate project escrows from non-Federal funds for the inappropriate disbursement of replacement reserves.
- 3B. Reimburse appropriate escrow accounts \$175,434 from non-Federal funds for the lost interest cited in this finding.
- 3C. Implement adequate quality control procedures to ensure that escrow accounts are maintained appropriately upon maturity of the Authority-held mortgages for new-regulation projects.

We recommend that the Director of HUD's Detroit Office of Multifamily Housing Programs

- 3D. Review the Authority's escrow maintenance to ensure that escrow funds were not disbursed inappropriately for the remaining 6 (28 – 22) new-regulation projects with matured Authority-held mortgages between October 2002 and December 2012. If deficiencies are noted, HUD should ensure that the Authority appropriately reimburses the deficient project escrows from non-Federal funds.

<sup>21</sup> See scope and methodology

## SCOPE AND METHODOLOGY

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We performed onsite audit work between November 2012 and June 2013 at the Authority's offices located at 735 East Michigan Avenue, Lansing, MI. The audit covered the period January 1, 2010, through September 30, 2012, but was adjusted as determined necessary.

To accomplish our objective, we reviewed

- Applicable laws; regulations; HUD's program requirements at 24 CFR Parts 880 and 883; Housing Notice H-2012-14; HUD Handbook 4350.1, REV-1; HUD Handbook 4370.2, REV-1; and legal opinions issued by HUD's and the HUD Office of Inspector General's (OIG) Offices of General Counsel.
- The Authority's accounting records; annual audited financial statements for 2009, 2010, and 2011; computerized databases; policies and procedures; board meeting minutes for January 2010 through September 2012; organizational chart; annual audited financial statements for new-regulation projects; capital needs assessment for new-regulation projects; and program assistance payments contracts and annual contributions contracts for all new-regulation projects.
- HUD's files for the Authority, program assistance payments contracts, and annual contributions contracts for all new-regulation projects.

We also interviewed the Authority's employees, property managers, and HUD staff.

Our review was limited to the information such as activity statements provided by (1) the Authority and (2) housing payments and project records maintained in the following HUD systems:

- Tenant Rental Assistance Certification,
- Integrated Real Estate Management, and
- Line of Credit Control System.

### **Finding 1**

We reviewed the Authority's vouchering and receipt of housing assistance payments for all 37 projects under a current new-regulation contract for the period November 2012 through May 2013.

We also reviewed the Authority's treatment of program residual receipts for the period November 2012 through May 2013 for all 37 projects under a current new-regulation contract.



The purpose of our review was to determine whether the Authority applied the program residual receipts for all new-regulation projects in accordance with HUD's requirements.<sup>22</sup>

## **Finding 2**

We also reviewed all of the 41 new-regulation projects administered by the Authority and determined that one project's contract had been split into two new-regulation contracts and three projects' new-regulation contracts had been terminated as of May 31, 2013. We reviewed the activity statements for all three projects to determine whether funds were appropriately remitted to HUD upon the termination of the projects' program contracts.

We reviewed the Authority's management of escrow funds for the three projects with terminated program contracts as of May 31, 2013.

We calculated interest using the U.S. Treasury's 10 –year interest rate, compounded daily, from the date the inappropriately maintained escrow funds should have been remitted to HUD through May 31, 2013.

## **Finding 3**

We also reviewed all of the 41 new-regulation projects administered by the Authority and determined that one project's contract had been split into two new-regulation contracts and three projects' new-regulation contracts had been terminated as of May 31, 2013. We determined that 37 (41 – 1 – 3) projects' contracts were current as of May 31, 2013. Of the 37 projects having a current contract, 28 project owners had paid off their initial Authority-held mortgage loan between October 2002 and December 2012. We judgmentally selected 22 of the 28 (79 percent) projects to review the Authority's management of project escrow funds.

We calculated interest, using the rate (compounded daily) provided by the Authority, that each individual project should have earned from the date of the inappropriate disbursement from replacement reserves through May 31, 2013.

We relied in part on data maintained by the Authority in its systems. Although we did not perform a detailed assessment of the reliability of the data, we performed a minimal level of testing and found the data to be adequately reliable for our purposes. Specifically, we confirmed that the monthly loan statements provided by the Authority matched the monthly loan statements we independently obtained from three projects. In addition, we independently determined the number of new-regulation projects administered by the Authority using HUD's system and the original housing assistance payments contracts. We provided our review results and supporting schedules to the Director of HUD's Detroit Office of Multifamily Housing Programs and the Authority's executive director during the audit.

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<sup>22</sup> Housing Notice H-2012-14, section V.C.

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

# INTERNAL CONTROLS

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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.

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## Relevant Internal Controls

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

- Effectiveness and efficiency of operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.
- Reliability of financial reporting – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.
- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

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:

- The Authority lacked an understanding of Federal requirements and sufficient quality control procedures to ensure compliance with HUD's requirements regarding the (1) use of program residual receipts, (2) remittance of excess project funds to HUD, and (3) appropriate maintenance of escrow funds (see findings 1, 2, and 3).

## APPENDIXES

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### Appendix A

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

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Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A			<u>\$31,148,477</u>
1B		\$428,804	
2A	608,337		
2B		<u>\$604,949</u>	
2C	12,830		
3A	290,437		
3B	<u>175,434</u>		
Total	<u>\$1,087,038</u>	<u>\$1,033,753</u>	<u>\$31,148,477</u>

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.
- 2/ 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.
- 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, if the Authority implements our recommendations, excess project funds will be used to reduce or offset Section 8 housing assistance payments.

## Appendix B

# AUDITEE COMMENTS AND OIG'S EVALUATION

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### Ref to OIG Evaluation

### Auditee Comments



RICK SNYDER  
GOVERNOR

STATE OF MICHIGAN  
MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY  
LANSING

SCOTT WOOSLEY, GFA  
EXECUTIVE DIRECTOR

September 4, 2013

Ms. Kelly Anderson  
Regional Inspector General for Audit Region 5  
Office of Audit  
U.S. Department of Housing and  
Urban Development  
Ralph H. Metcalfe Federal Building  
77 West Jackson Blvd., Suite 2201  
Chicago, Illinois 60604-350

VIA E-MAIL

Re: September 2013 Audit Report of the Michigan State Housing Development  
Authority (Multifamily Project-Based Section 8 Program - New Regulation Only)

Dear Ms. Anderson:

We are writing you in response to the discussion draft audit report findings enclosed with your letter dated August 15, 2013. Our responses to the proposed Findings are listed after the statement of each Finding header made in the report.

First, however, we believe it may be illuminating to briefly describe the context in which the audit was made.

#### **Background**

The Authority is a State Agency that has financed the construction of affordable multifamily projects receiving project-based Section 8 Housing Assistance Payments ("HAP") under Title 24, Part 883 of the Code of Federal Regulations. Under the Part 883 regulations, it was the responsibility of the State Agency to provide loans for the construction and permanent financing of the projects. The loans were not insured by the federal government. As part of the regulatory scheme and in recognition of the fact that they provided financing for these projects without HUD mortgage insurance, the State Agencies were allowed exclusive authority over many aspects of the Part 883 program, including the rights to act as contract administrator of the

**Comment 1**

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Housing Assistance Payments contract, to underwrite the project, to establish a proper rate of return to the project owner, to establish reserves and to approve the use of project funds. The respective rights and obligations of the parties were set forth in the Annual Contributions Contract ("ACC") entered into between HUD and the State Agency, and the Housing Assistance Payments Contract ("HAP Contract") between the State Agency and the project owner. The terms of the HAP Contracts under this program were tied to the maturity date of the State Agency financing.

The Part 883 regulations were substantially revised in 1979 and 1980, along with the regulations for the other project-based Section 8 programs. The revised regulations (the "new regulations") imposed a number of new requirements, such as a maximum limit on the owner's return and the maintenance of a replacement reserve for the projects. The new regulations still reserved exclusive control to the State Agencies over certain aspects of underwriting, the use of surplus project funds<sup>1</sup> and the right to establish a lesser rate of return. The State Agencies were also given the right to control the level of funding and to establish the guidelines for the use of the now-required replacement reserve. It is extremely important to note that with respect to other Section 8 project-based subsidy programs, HUD retained the rights and obligations granted to State Agencies under Part 883. This clearly indicates that Congress intended for projects financed under Part 883 to be treated differently than other projects where HUD controls the use of reserves.

In 2012, HUD issued Housing Notice H-2012-14 ("Notice"). This Notice directed all contract administrators of so-called "new regulation" Section 8-assisted projects to report on the amount of "Residual Receipts" (HUD's term for surplus project funds) held and to apply all Residual Receipts in excess of \$250 per unit to offset future HAP. On September 24, 2012, the Authority sent a letter to the Deputy Assistant Secretary for Multifamily Housing Programs stating that HUD did not have the authority to alter the federal regulations applicable to projects constructed under Part 883 and that therefore the Notice did not apply to those projects. In November of 2012, the Authority was notified by the HUD Office of Inspector General of the subject audit. Following further discussions with local HUD staff, the Authority conducted an

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<sup>1</sup> 24 CFR 883.306(e) provides:

"If the HFA determines at any time that surplus project funds are more than the amount needed for project operations, reserve requirements and permitted distributions, the HFA may require the excess to be placed in a separate account to be used to reduce housing assistance payments or for other project purposes. Upon termination of the Contract, any excess project funds must be remitted to HUD."

HFA is defined in 24 CFR 883.203 as "A State Agency which provides permanent financing for newly constructed or substantially rehabilitated housing processed under subpart D and financed without Federal mortgage insurance or a Federal guarantee except coinsurance under Section 244 of the National Housing Act".

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analysis of all operating reserves held by it for Part 883 "new regulation" projects to determine whether surplus project funds were available, and agreed to release surplus project funds, as determined by the Authority, to offset HAP. The Authority began voluntarily implementing the offsets in May of 2013, in accordance with instructions from the Director of the Office of Housing, Michigan State Office, in her letter dated March 27, 2013.

**Finding 1: The Authority Did Not Use Residual Receipts to Reduce or Offset Housing Assistance Payments.**

The Authority disagrees with Finding 1.

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Comment 3

The OIG found that the Authority (i) failed to use more than \$31.1 million in available surplus project funds to reduce or offset housing payments as required by HUD beginning in November of 2012, and (ii) inappropriately disbursed residual receipts in the amount of \$429,000. Further, the OIG concluded that these "weaknesses" occurred because the Authority has a "lack of understanding of Federal requirements regarding its role in administering the program." This finding is inflammatory, arbitrary and untrue in every material respect.

Comment 4

First, we believe that HUD and the OIG willfully misrepresent the meaning of "Residual Receipts" in the Section 8 project-based programs and thus disregard that fact that HUD's policies on "Residual Receipts" should not apply to the Authority's Part 883 projects.

"Residual Receipts" (although the term is not used in any of the Part 880, Part 881 or Part 883 Regulations) is a concept that applies only to HUD-insured or HUD-held loans. The calculation and use of Residual Receipts funds is restricted by HUD policy. For Part 883 uninsured projects, however, the State Agency is charged with determining whether a project has "surplus project funds," placing them in a separate account if it chooses and ensuring that they are used for project purposes. Under this authority, MSHDA's policies with respect to the deposit of available cash flow into the "Operating Reserve Cash" account, or ORC, and the use of those funds are not the same as HUD's, yet despite repeated explanations, neither HUD nor the OIG seems willing to recognize the difference, as set forth in the Part 883 Regulations for more than 30 years. Part 883 owners are required to use the Authority's audit guidelines, not HUD's, to calculate and determine available cash, and this practice has been left unchallenged by HUD for nearly 35 years. Under HUD's audit guidelines, surplus funds are calculated and placed in the Residual Receipts account *after* funding reserves, payment of project expenses and the owner has received its limited distribution. The owners of Authority-financed projects, however, are required to submit all "funds available for distribution" to the Authority with the annual audit. Only after the audit is approved is the owner permitted to draw the amount due as its limited distribution for the prior year from the ORC account. Accordingly, the operating reserve cash of an Authority-financed development is always available for distributions to the owner.



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Comment 4

The Authority treats the ORC account as an extension of the property's operating account, not as "surplus". Funds are routinely moved in and out of the ORC account, and may be used for any operating needs of the property. Unlike HUD, which characterizes all funds on deposit in the Residual Receipts account as surplus or excess, the Authority does not make a final determination of whether a project truly has surplus funds until the Authority's loan is repaid. We believe that this is consistent with the intent and purpose of the Part 883 regulations.

Comment 4

Moreover, surplus project funds are *not* (as mistakenly presumed by the OIG) equal to the amount of funds on deposit in the ORC account at any point in time, but must be calculated after taking into account any cash in the project's operating account, accrued and outstanding payables, receivables, unpaid limited distributions to the owner, whether any funds on deposit in the reserve were owner-funded<sup>2</sup>, funds available in other project reserves, and interest.

Comment 5

We note that HUD contradicts itself with respect to the purported applicability of the Notice. We refer to HUD's Multifamily Asset Management and Project Servicing (Handbook 4350.1 REV-1), which applies to all, or nearly all, federally-subsidized housing programs and has been in use for over 20 years. Chapter 25 of the Handbook sets forth HUD's basic policy with respect to Residual Receipts. Paragraph 25-1 states: "This Chapter applies to all...projects with HUD-insured and HUD-held mortgages, including the Section 202 Program projects." According to its own long-standing guidance, HUD's policies on Residual Receipts do not apply to uninsured State Agency projects, and therefore, the Notice, which deals exclusively with "Residual Receipts," should not apply to Part 883 projects.

Comment 6

We further note that the draft audit report states in its analysis for Finding 1 that "... [surplus project] funds belong neither to the Authority nor the project owner but, rather, to HUD." The OIG's assertion echoes the statement made by the Deputy Assistant Secretary for Multifamily Housing Programs, in her letter to the Authority dated October 23, 2012: "...these funds ... belong neither to the HFA nor to the project owner but, rather, to the United States." HUD relies on this conclusion to justify the applicability of the Notice to Part 883 projects. We again refer HUD and the OIG to Handbook 4350.1, Paragraph 25-2, on Residual Receipts, which states: "During the life of the mortgage (except for certain Section 8 projects that are described in paragraph 25-11 of this Chapter), Residual Receipts *are an asset of the mortgagor* held under HUD control." (Emphasis added.) And under the Part 883 Regulations, "surplus project funds" are held under *State Agency* control, rather than HUD, which is, again, consistent with the regulatory scheme, under which the control of these *mortgagor* funds is given to the State Agency as *mortgagee*.

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<sup>2</sup> Many new regulation owners were required to deposit some of their own funds in the operating reserve cash account as a condition of loan closing.

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Comment 7

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Based on the foregoing, we assert that the OIG's Finding 1 cannot be supported and is deeply flawed, as the result of its lack of understanding of the federal regulations applicable to Part 883, uninsured State Agency-financed projects.

Second, although the OIG maintains that the Authority should have begun to offset HAP in November of 2012 because the Notice states that it will be effective with vouchers submitted 60 days after issuance of this Notice<sup>3</sup>, the Authority did not receive explicit direction from the HUD to begin the offset of HAP until it received the letter dated March 27, 2013, from the Director of the Office of Housing, Michigan State Office.<sup>4</sup> That correspondence directed the Authority to implement the offset with the vouchers filed in May of 2013 and apply surplus funds to offset the June HAP payments. The Authority implemented the offset process in May and June as directed. We note that Section VII.B.1 of the Notice also provides this direction on when to begin the offset process:

Prior to the first required offset of Residual Receipts, the Hub/PC shall notify the PBCA or TCA at least 45 days in advance of the proposed effective date of the offset. The effective date of the offset will be the first day of the month which follows the conclusion of the 45-day period.

a. Example #1: If the Hub/PC notifies the PBCA or TCA that HUD has directed the offset on June 15th, the offset will be made effective on August 1st.

The Authority could not have implemented the offset until it received the required notice from HUD, and that notice was not given until March 27, 2013.

Third, although the Authority is holding slightly more than \$30 million<sup>5</sup> in operating reserve cash (again, this not the same as Residual Receipts, a term that applies only to HUD-held and HUD-insured projects) for new regulation projects financed under Part 883, in fact the Authority has already determined that more than \$22 million in operating reserve cash held by the Authority could be characterized as surplus funds. The Authority voluntarily agreed to make these funds available for the purpose of offsetting HAP, solely to assist HUD with its budgetary

<sup>3</sup> Section III.C of the Notice provides: "This Notice will be effective with vouchers submitted 60 days after issuance of this Notice. "

<sup>4</sup>The letter from HUD is attached to this letter.

<sup>5</sup> Not \$31,148,478 as asserted by the OIG. See attached worksheet entitled "Comparison of MSHDA ORC Balances to OIG Residual Receipts Balances as of 5-31-2013".

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concerns, and to date has released \$899,429 to offset voucher payments to owners<sup>6</sup>. As of August 28, 2013, the balance of surplus funds that the Authority will make available to offset HAP is \$22,327,051.89<sup>7</sup>, plus a minor amount of interest. The amount of operating reserve cash that is not available for offset of HAP is \$6,833,580.26; not more than \$31 million. Of this, \$6,479,106.33 is reserved for two Preservation loan transactions. These developments were included with 14 other developments as part of a \$72,165,000 tax-exempt bond issue for which the Authority published formal notices of funding, as required by TEFRA<sup>8</sup>, in August of 2012. Although the bonds were not actually issued until December of 2012, the bond transaction was structured to include these two projects as far back as July of 2012, well before the Notice was issued. If these loans are not made due to the loss of their reserves as a funding source for the rehabilitation work to be undertaken as part of the transaction, the Authority will suffer not only direct financial losses from its inability to recoup the costs of issuance, but its reputation could suffer and its costs of doing business could rise if the Authority is forced to issue an "unused bond proceeds call" to the purchasers of its bonds in the marketplace. Although we do not believe HUD's approval is required, as the Authority has control over the use of project reserves, the owners requested HUD's approval to use available project reserves for these transactions but HUD denied the request. At present, the transactions are on hold.

Comment 8

The other \$354,473.93 is reserved for five developments<sup>9</sup> that are projected to experience negative operations during the life of their Authority-financed mortgage loans. This number is less than the number originally provided to HUD. Following discussions with Michigan Office staff and the OIG, the Authority revised its numbers to take into account separate, mortgage-funded reserves that had been established as part of several preservation transactions.

Comment 9

Fourth, four of the disbursements from ORC accounts that were deemed inappropriate by the OIG were for necessary project expenses, reserve requirements or permitted distributions. Those disbursements are detailed in the footnote below.<sup>10</sup> Surplus project funds do not exist

<sup>6</sup> See attached worksheet entitled "Adjustments to ORC".

<sup>7</sup> See attached worksheet entitled "Current ORC Balances as of 8-28-2013".

<sup>8</sup> Tax Equity and Fiscal Responsibility Act of 1982.

<sup>9</sup> MI33-H150177 (Freedom Place), MI28-H150223 (Phoenix Place), MI28-H150202 (Birch Park), MI33-H150080 (Coventry Woods) and MI28-H150204 (Lawrence Park)

Comments 9  
and 10

<sup>10</sup> (1) MI28-H150223 (Phoenix Place), MI28-H150202 (Birch Park), MI33-H150080 (Coventry Woods) and MI28-H150204 (Lawrence Park) are all under court-ordered receivership. All four developments were found by the receiver to be struggling with substantial payables and deferred maintenance and repairs; no operating funds were turned over to the receiver by the owner-affiliated management agent that had been managing the properties, and at the request of the receiver, funds were disbursed from some of the developments' operating reserve accounts to pay utility bills and other necessary vendor services

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Comment 11

unless they are in excess of the amount needed for those items and therefore, the Authority will not comply with the recommendation to reimburse these funds to the project ORC accounts.

Comment 12

The other two disbursements<sup>11</sup> were also for necessary project expenses, but as these expenses were eligible to have been funded from the projects' replacement reserves<sup>12</sup>, to appease HUD we have therefore transferred funds into the ORC accounts from the replacement reserves in the amounts noted, plus interest in the recommended amount. Contrary to the recommendation of the OIG, however, in no way are funds in the projects' operating reserve cash or ORC accounts owed to HUD, so long as the HAP Contract is in effect. Thus, regardless of the Notice's purported applicability to Part 883 projects, if the substance of the OIG's assertion were correct, any funds disbursed to an owner for project expenses in excess of the amount permitted by the Notice would be reimbursable to the project's ORC account, not HUD.

Comments 1,  
3, 4, and 6

Fifth, in support of its conclusion that the Authority lacks understanding of the federal requirements regarding its role as contract administrator, in Appendix C the OIG cites a number of federal regulations and refers to the form of ACC between HUD and the Authority. Both the ACC and the applicable regulations state that the *Authority*, not HUD, has the right to make a determination of whether there are surplus project funds, and that the *Authority*, not HUD, may require the excess to be used to reduce Housing Assistance Payments. The OIG also cites the

Comment 13

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that were aged more than 90 days. Failure to comply with the receiver's request would result in a court order that, if ignored, would place the Authority at risk of being in contempt of court. Relevant portions of the last two reports submitted by the receiver to the court are attached to this letter. As can be seen, all the projects that are the subject of the receivership are experiencing significant financial difficulties and additional infusions of funds will be needed.

(2) MI28-H150080 (Redford Opportunity House) experienced a shortfall in its tax and insurance escrow, and in keeping with Authority written policy on the use of the ORC, \$2,623 was transferred from the development's operating reserve account to pay taxes and insurance. The payment of taxes and insurance are necessary expenses of operation, and a surplus does not exist if those expenses must go unpaid.

(3) MI33-H150193 (Mari Dan Miller) did not have any funds in the operating reserve account in excess of the HUD threshold amount of \$250 per unit until March of 2013, when this project's owner submitted its annual audit along with operating "funds available for distribution" from the prior year [not to be confused with Residual Receipts, or surplus project funds, as defined by 24 CFR §883.306(e)], as determined by the audit, and was permitted to draw its approved limited distribution for the prior year. The Notice does not prohibit owners from receiving permitted limited distributions on an annual basis to the extent that cash from operations is available. 24 CFR §883.306(b) establishes the right of a for-profit owner to a limited distribution, or return on investment.

<sup>11</sup> MI28-H150183 (Northport) and MI33-H150076 (Pine Way).

<sup>12</sup> Per Authority policy, owners are permitted to draw funds for replacement reserve eligible items from the project's operating reserve, if funds are available, in order to protect the replacement reserve.

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3, 4, and 6

Comment 14

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Notice as overarching and controlling, despite the clear language of the applicable federal regulations and the ACC.

In this respect, it is worth noting that the OIG falsely and repeatedly characterizes the Notice and its directives as "regulations", when in fact they are not regulations, and do not have the effect of law<sup>13</sup>. Only regulations that are properly promulgated in accordance with the federal administrative procedures act have the effect of law. The law may not be altered by contractual agreement, regardless of HUD's assertions to the contrary. Nor may contracts be unilaterally amended by one party unless the right to do so has been reserved under the contract. Although the OIG also cites Section 1.2 of Part I of the ACC to support its right to unilaterally amend the terms of the ACC by issuance of the Notice, the OIG failed to include the last sentence of Section 1.2, which states: "However, neither the HFA nor HUD shall assume any obligation beyond that provided in the HUD-approved Agreement and Contract." While HUD has the right to provide the guidance and detail necessary to implement the terms of the ACC, it does not have the right to alter the obligations (or rights) of the parties. No matter how carefully the OIG seeks to mischaracterize the nature of the Notice, how often it misrepresents what the actual regulations provide, and how extensive and creative its pretexts for disregarding the regulations and contracts in effect, the law is clear. The job of the OIG is to acknowledge what the law requires, state whether it is being followed, and if it deems it appropriate, to recommend changes in the law. That is not what the OIG has done in this audit report.

Federal law requires the policies and procedures of a public agency to be rational and reasonable. HUD's pronouncement that surplus project funds include all project funds in excess of \$250 per unit is arbitrary and capricious, for it is not based on a reasoned, project-by-project analysis, and disregards not only the clearly stated regulations on what constitutes surplus, but the real financial needs of a particular project. To disburse project funds for the purpose of offsetting HAP payments when it has been determined that those funds will in all likelihood be needed to cover future project operating expenses, debt service and reserve requirements would be an abuse of trust and our fiduciary duty. We would be negligent in our responsibility to project owners and the tenants who are the ultimate beneficiaries of the federal housing subsidy programs if we compromised project security and stability by stripping away crucial project reserves. Had all the funds been reimbursed to HUD as the OIG is recommending, some of these projects would now be in default or have their utilities shut off, and the tenants homeless.

<sup>13</sup> "An agency's interpretive rules which are not subject to the federal Administrative Procedures Act do not rise to the level of a regulation and do not have the effect of law. Indeed, interpretive rules are not intended to have any legal effect." §234, Am Jur 2nd (2013). "Agency interpretations of regulations such as interpretations in opinion letters, like interpretations contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law, do not warrant deference." Miller v. Bank of America, 46 Cal 4th 630, 94 Cal Rptr 3d 31, 207 P3d 531 (2009), as cited in §235, Am Jur 2nd (2013).

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The Authority emphatically maintains that the applicable regulations and the ACC state the rights and obligations of the parties and that the Notice does not and cannot apply to Part 883 State Agency-financed projects. The Authority is not, as maintained by HUD, a mere contract administrator who must accept direction from HUD on every issue, but the HFA charged by federal law with the original financing obligation, and the continuing oversight responsibility for Part 883 projects. We believe that it is HUD and the OIG, not the Authority, who do not understand the federal requirements of the Part 883 Program.

Comment 17

The Authority emphatically rejects all recommendations of the OIG made in connection with Finding 1 as they are based on unfounded, erroneous conclusions and contradictory legal analysis, and do not merit any response.

**Finding 2: The Authority Did Not Remit Excess Project Funds to HUD.**

The Authority agrees in part with Finding 2.

Comment 18

The first HAP Contract<sup>14</sup> included in the draft report terminated in 2007. Following contract termination, the Authority remitted funds in the development's operating reserve, as we agreed that these funds constituted surplus project funds, to HUD. We did not remit funds in the development's replacement reserve, as in the Authority's interpretation of the applicable regulations, these funds do not necessarily constitute surplus project funds. A project's replacement reserve is established for capital items that must be funded over time, and funds are set aside early on to cover components after they have reached the end of their useful life. Despite the termination of a HAP Contract, a project may have enormous capital needs and the stripping away of a carefully built-up replacement reserve would leave the project with no ability to make necessary capital replacements. Surplus project funds are, according to 24 CFR §883.306(e), only surplus if they are more than what is needed for reserve requirements. With respect to VPCA, however, in retrospect we realize that because the development was sold and ceased operating as affordable housing shortly after termination of the HAP Contract, the replacement reserve was unnecessary and should have been deemed surplus. Although we disagree with the amount cited by the OIG for the reasons explained in the footnote below<sup>15</sup>, we will remit the surplus funds (as determined by the Authority) to HUD, with interest. A copy of the letter sent on July 24, 2013, as corrected by letter dated August 22, 2013, to the Director of

Comment 19

<sup>14</sup> MI28-H150160 (VPCA).

<sup>15</sup> The information provided to the OIG auditors did not reflect that the amount of \$4,114.35 was released from the project's replacement reserve to pay accrued liabilities for taxes and insurance, and that only the amount of \$77,829.57 was transferred to the Authority's Preservation Fund.

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Multifamily Housing, Detroit Multifamily Hub, requesting direction for where the funds should be wired, is attached to this letter.<sup>16</sup>

The second HAP Contract<sup>17</sup> listed in the draft report terminated on February 28, 2013, during the audit review period. Until some time in late April or early May of 2013, the owner continued to engage HUD in discussions about reinstating and renewing the expired contract. When HUD finally notified the Authority on May 13, 2013, that the owner could not, in fact, reinstate their HAP Contract<sup>18</sup>, Authority staff requested financial information from the small non-profit owner so that a determination of surplus cash could be made. As noted above, surplus project funds are not equal to the amount of funds on deposit in Authority-held reserves at any point in time, but must be calculated after taking into account all operating and other financial aspects of the property. The owner failed to respond to the Authority's request for information<sup>19</sup>, so eventually Authority staff attempted to ascertain accrued payables such as taxes and insurance and outstanding replacement reserve needs in order to calculate the amount of surplus funds. Although we disagree with the amount cited by the OIG, we will remit the surplus funds (as determined by the Authority) to HUD. A copy of the letter sent on July 24, 2013, to the Director of Multifamily Housing, Detroit Multifamily Hub, advising her of the amount of surplus project funds and requesting direction for where the funds should be wired, is attached to this letter.<sup>20</sup>

Comment 21

The third HAP Contract<sup>21</sup> included in the draft report terminated as of December 31, 2012. Prior to contract termination, the Authority accepted a deed in lieu of foreclosure of the Authority's mortgage loan from the owner of this property located in Saginaw, Michigan. After a long history of problems, HUD and the Authority concluded that the property was no longer viable as a subsidized housing development, and the decision was made to issue vouchers, permanently relocate all tenants and terminate the HAP contract. Following the transfer of title

<sup>16</sup> On September 3, 2013, HUD's response was finally received. A copy of that letter is also attached. In accordance with the instructions set forth in the letter, the sum of \$85,629.60 has today been wired to the U.S. Treasury.

<sup>17</sup> MI33-H150050 (Moore Apartments)

<sup>18</sup> The e-mail chain between HUD and the Authority and the project owner is attached.

<sup>19</sup> Finally, on August 24, 2013, the non-profit owner did respond to the Authority's request for information.

<sup>20</sup> On August 28, 2013, HUD's response was finally received. A copy of that letter is also attached. In accordance with the instructions set forth in the letter, the sum of \$254,287.58 has today been wired to the U.S. Treasury.

<sup>21</sup> MI28-H150191 (Bancroft Eddy)

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Comment 21

to the Authority, the Authority worked closely with HUD staff to ensure the HAP contract remained in place long enough to secure vouchers and locate replacement housing for the residents. During that time, existing project reserves were maintained (as required by federal regulations and the HAP contract), and were used to meet operating obligations and pay for necessary repairs to the property. The tenants were finally moved out in December of 2012, and the HAP Contract was terminated. The property was then sold for a net to the Authority of \$371,851.48 (however, \$350,000 of the \$400,000 purchase price had to be set aside to pay for environmental clean-up costs and other closing costs were incurred), resulting in a loss to the Authority in the amount of \$3,571,250.21 . Pursuant to the mortgage loan documents approved by HUD<sup>22</sup> for the property, Authority-held reserves totaling \$698,563.44 were applied to partially reimburse the Authority for its loss, leaving the Authority with a net write-off for bad debt of \$2,872,686.77. As this can hardly be characterized as surplus, no excess project funds were available to be remitted to HUD. Although we do not believe that any further HUD approval is required, a copy of the letter dated July 24, 2013, to the Director of Multifamily Housing, Detroit Multifamily Hub, requesting her approval for the offset of project reserves against the unpaid mortgage liability, is attached to this letter. To date, no response has been received.

Comment 17

The Authority does not agree with any of the OIG's recommendations made in connection with Finding 2. Not only has the OIG failed to calculate properly the amount of surplus funds in each case, but it contends that surplus funds should be remitted to HUD within one business day of the effective date of contract termination, which is not only unreasonable but impossible for the reasons noted above. Further, the OIG's contention that HUD approval is required for the Authority to apply funds on deposit in project reserves to a project's unpaid mortgage debt is contrary to both the project loan documents and years of practice during which HUD has routinely granted its approval to the pledge of HAP funds to secure the repayment of loans by commercial lenders and HFAs on HUD-subsidized projects.

Comment 22

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<sup>22</sup> Section 1 of the Pledge Assignment and Security Agreement between the mortgagor and the Authority provides as follows:

Comment 23

1. As security for the performance of all current and future obligations of the Pledgor under the Loan Documents . . . Pledgor hereby irrevocably and unconditionally pledges with and assigns to the Authority as Pledgee, and grants to the Authority as Pledgee a security interest in, all rights, including . . . any and all proceeds derived therefrom which the Pledgor now has or may hereafter acquire in, through or under the Section 8 Contracts from or against the Authority as HFA or HUD including without limitation the Pledgor's right to receive Assistance Payments from the Authority and the Pledgor's rights under Section 2.16 of the ACC.

A copy of this Agreement, which was signed as "Approved" by HUD, is attached to this letter.



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Comments 22  
and 24

We must also point out that HUD does not have a written process in place that gives guidance to mortgagees on how, where or when to remit surplus funds following a contract termination. It is startling to us that a finding could be made, and interest assessed on the unpaid sums, for violating a process *that does not exist*. The OIG's position that remittance of any remaining reserves to HUD should occur within one business day of the effective date for the termination of the HAP Contract - considering that over a month elapsed before we received direction from HUD on payment on two projects cited in the draft report - is irrational. Not only does it take time to gather essential information from the owner, ensure that all outstanding liabilities of the property are addressed, reconcile the various reserves and post accrued interest for the end of the reporting period, we must then wait for direction from HUD on where and how to remit the funds. A minimum of one month and usually two are required for all of this, even when the owner is cooperative. We will, however, work with our Hub to establish a *reasonable* procedure for handling the remittance of surplus funds following contract terminations.

Comment 25

**Finding 3: The Authority Inappropriately Disbursed Replacement Reserves.**

The Authority disagrees with Finding 3.

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The OIG based this finding on the Authority's release of funds held in project replacement reserves to four project owners after a sale and refinancing. In each case, the funds were released in accordance with Authority policy that allowed an owner who paid its Authority loan in full to draw any accumulated, unpaid limited distributions due the owner from surplus project funds. The OIG concluded that the Authority failed to appropriately maintain escrow accounts upon maturity of the Authority's loan.

Federal regulations<sup>23</sup> require that a replacement reserve "be established and maintained in an interest-bearing account to aid in funding extraordinary maintenance and repair, and

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<sup>23</sup> Relevant subsections of the applicable regulation (and former 24 CFR §883.703) are:

**§ 880.602 Replacement reserve.**

(a) A replacement reserve must be established and maintained in an interest-bearing account to aid in funding extraordinary maintenance and repair and replacement of capital items.

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(2) *Part 883 of this chapter projects.*

(i) For 24 CFR Part 883 projects, an amount equivalent to at least .006 of the cost of total structures, including main buildings, accessory buildings, garages and other buildings, or any higher rate as required from time to time by: (A) The Agency, in the case of projects approved under 24 CFR part 883, subpart D; or (B) HUD, in the case of all other projects, will be deposited in the replacement reserve annually.

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replacement of capital items." The replacement reserve "must be built up to and maintained at a level determined to be sufficient *by the Agency....*" Further, the funds "may be drawn from the reserve and used only in accordance with *Agency guidelines* and with the approval of, or as directed by, *the Agency*". (Emphasis added.) As noted above, this is consistent with the financing responsibility and risk borne by the State Agency for these projects. Therefore, it is the sole responsibility and the obligation of the Authority to determine the appropriate level of the replacement reserve for a project financed by the Authority and to release the surplus for any proper purpose permitted by the regulations, the ACC and the HAP Contract.

When Agency financing is not used and instead a HUD-insured mortgage finances a development, however, the ACC and contract administration duties are assigned to the PBCA portfolio, and this responsibility shifts to HUD. Two of the projects cited by the OIG<sup>24</sup> were refinanced with HUD-insured mortgages when the Authority's loan was prepaid, and as part of that refinancing, the developments were substantially rehabilitated, all CNA<sup>25</sup> items were addressed, and new replacement reserves were established at the funding level required by HUD. Consequently, and as permitted by the applicable regulations<sup>26</sup> and the HAP Contracts<sup>27</sup>, the Authority determined that the remaining replacement reserves held by it for those projects were "surplus funds" in excess of what was needed for "reserve requirements and project operations", and approved the release to pay permitted distributions to the owner.

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(ii) The reserve must be built up to and maintained at a level determined to be sufficient by the Agency to meet projected requirements. Should the reserve achieve that level, the rate of deposit to the reserve may be reduced with the approval of the Agency.

(iii) All earnings, including interest on the reserve, must be added to the reserve.

(iv) Funds will be held by the Agency, other mortgagee or trustee for bondholders, as determined by the Agency, and may be drawn from the reserve and used only in accordance with Agency guidelines and with the approval of, or as directed by, the Agency.

<sup>24</sup> MI28-H150209 (Clement Kern) and MI33-H150074 (Blair Park).

<sup>25</sup> CNA means "Capital Needs Assessment." A CNA is a comprehensive report prepared by a third party that reviews all physical components of a development and provides estimates of their remaining useful life, a schedule for replacement, and the costs of replacement.

<sup>26</sup> 24 CFR §883.306(b) establishes the right of a for-profit owner to a limited distribution, or return on investment. 4 CFR §883.306(e) provides that only project funds that are more than the amount needed for permitted distributions, required reserves and project operations are considered surplus. 24 CFR §883.306(d) provides that any short-fall in return may be made up from surplus project funds in future years.

<sup>27</sup> Section 2.5(e)(4) of the new regulation HAP Contract between the project owner and the Authority provides that "Any short-fall in return may be made up from surplus project funds (see paragraph (c)(1)) if permitted by the HFA in future years in accordance with HFA requirements." (Emphasis added.)

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One of the projects<sup>28</sup> was refinanced by the Authority. Following the substantial rehabilitation of the development, utilizing the existing replacement reserve as a source for the payment of hard construction costs, a new replacement reserve was established at a level determined by the Authority to be sufficient. This reserve is paid into on a monthly basis. Other necessary reserves were established from mortgage loan proceeds and owner equity funds. The small amount of funds remaining in the existing replacement reserve (\$2,504) from the accrual of additional interest prior to closing was deemed "surplus funds" in excess of what was needed for "reserve requirements and project operations". As permitted by the applicable regulations<sup>29</sup> and the HAP Contract<sup>30</sup>, the Authority approved the release of the surplus to pay permitted distributions to the owner.

Comment 26

The fourth project<sup>31</sup> was also refinanced, in that case neither by the Authority nor with a HUD-insured loan. Again, however, the project was substantially rehabilitated, all CNA needs were addressed, and a replacement reserve was properly established with the new lender. This reserve is being paid into on a monthly basis. Because the ACC and the contract administration duties for this development were assigned by HUD to the PBCA portfolio, HUD, not the Authority, now has the responsibility for the oversight of its replacement reserve. Therefore, as permitted by the applicable regulations<sup>32</sup> and the HAP Contract<sup>33</sup>, the Authority determined that

<sup>28</sup> MI33-H150080 (Coventry Woods).

<sup>29</sup> 24 CFR §883.306(b) establishes the right of a for-profit owner to a limited distribution, or return on investment. 4 CFR §883.306(e) provides that only project funds that are more than the amount needed for permitted distributions, required reserves and project operations are considered surplus. 24 CFR §883.306(d) provides that any short-fall in return may be made up from surplus project funds in future years.

<sup>30</sup> Section 2.5(e)(4) of the new regulation HAP Contract between the project owner and the Authority provides that "Any short-fall in return may be made up from surplus project funds (see paragraph (c)(1)) if permitted by the HFA in future years in accordance with HFA requirements." (Emphasis added.)

<sup>31</sup> MI33-H150072 (Camelot Hills).

<sup>32</sup> 24 CFR §883.306(b) establishes the right of a for-profit owner to a limited distribution, or return on investment. 4 CFR §883.306(e) provides that only project funds that are more than the amount needed for permitted distributions, required reserves and project operations are considered surplus. 24 CFR §883.306(d) provides that any short-fall in return may be made up from surplus project funds in future years.

<sup>33</sup> Section 2.5(e)(4) of the new regulation HAP Contract between the project owner and the Authority provides that "Any short-fall in return may be made up from surplus project funds (see paragraph (c)(1)) if permitted by the HFA in future years in accordance with HFA requirements." (Emphasis added.)

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Comment 25

the remaining replacement reserve held by it for this project was "surplus funds" in excess of what was needed for "reserve requirements and project operations", and approved the release to pay permitted distributions to the owner.

The Authority does not agree with the OIG recommendations that the Authority reimburse project escrows for sums that were properly released to owners. Contrary to the OIG's conclusion, the Authority does appropriately maintain escrow accounts upon maturity or prepayment of Authority-held mortgages for new regulation projects. Since learning of HUD's claim to any remaining replacement reserve funds as well as excess project funds, the Authority has halted its practice of releasing excess replacement reserves to owners who are entitled to the payment of limited dividends following a prepayment. Owners are being advised that HUD's consent should be sought for any release. To avoid further disputes with HUD over this issue, the following will be added to the Authority's staff procedures for handling the loan pay-off of a Section 8 new regulation project:

Comment 27

As part of the escrow reconciliation, Owners should be informed that no replacement reserves, operating reserves or other reserves, except (i) those funded from mortgage loan proceeds or owner equity funds and (ii) excess tax and insurance escrows, will be released to the owner or transferred to a new lender without HUD's consent, regardless of the owner's right to the payment of accumulated limited dividends.

Comment 28

**Conclusion**

The Authority protests this apparent effort by HUD to punish the Authority for exercising its right to speak in defense of HUD's own regulatory regime for Part 883 projects and to engage in a legitimate dispute over the applicability of the Notice. It is our understanding that following our correspondence to HUD expressing our disagreement with their proposed implementation of the Notice, HUD staff asked the OIG to audit the Authority and its handling of reserves. This appears to be an attempt by a federal department with a budget deficit to intimidate a state agency by taking money from the states and from the projects and the residents that HUD policies are intended to protect.

Comments 6 and 15

The Authority also protests audit findings that are based solely on one party's interpretation of the applicable law and the terms of a legal contract, when the meaning and effect of the law and the contract are the subject of a good faith dispute with another party. The acceptance without question by the OIG of the assumptions and questionable interpretation of the law made by the federal agency it is appointed to oversee is inappropriate and shows that the OIG clearly lacks independence in conducting this audit. Moreover, to conduct an audit for

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compliance with federal requirements before the dispute is resolved and it is known what the law and the contract truly require is irresponsible and premature.

We strongly urge the OIG to reconsider its findings and revise the draft audit report to reflect our responses as necessary. In general, the findings are unsupported and unwarranted. The injury to the Authority that will result from the publication of these accusations is very real. The extremely small number of actual errors that were discovered in our administration of this program indicates that our staff are in fact very capable, and the Authority is substantially in compliance with federal requirements. Our response also shows that when we do learn of an error, we correct it promptly.

Regardless of the outcome, however, the Authority and its staff will continue to cooperate with our partners at HUD in the administration of federal housing programs here in Michigan, as the preservation of affordable, decent, safe and sanitary housing for the low and moderate income residents of Michigan is also very much our purpose and our goal.

Sincerely,



Scott Woosley  
Executive Director

Enclosures

cc: Barbara Chiapella  
Susie Sapilewski  
Donna McMillan  
Christopher LaGrand  
Clarence L. Stone, Jr.  
Corina Andorfer

## OIG's Evaluation of Auditee Comments

**Comment 1** We acknowledge that HUD's regulations at 24 CFR 883.306(e) effective February 29, 1980, permits the housing finance agency to assume responsibility for (1) project development, (2) supervision of the development, and (3) the management and maintenance functions of owners subject to HUD periodic review and monitoring by HUD. The Authority is entitled to a reasonable fee, determined by HUD, for administering a contract. In regards to the use of surplus funds, we also acknowledge that the regulation stated that if the Authority determines at any time that surplus project funds are more than the amount needed for project operations, reserve requirements, and permitted distributions, the Authority may require the excess to be placed in a separate account to be used to reduce housing assistance payments or for other project purposes.

However, upon termination of the contract, any excess project funds must be remitted to HUD. The executed housing assistance payments contract further expounds on this requirement stating that surplus project funds must be deposited with the agency, mortgagee, or other agency approved depository in an interest bearing account. Withdrawals from the account will be made only with the approval of the Authority for project purposes, including the reduction of housing assistance payments. Therefore, the agency does not have exclusive control of surplus funds since HUD is limiting the use of the surplus funds to project related purposes and stating that the funds ultimately belong to HUD.

**Comment 2** As a result of our audit, the Authority conducted an analysis of its program projects escrow accounts to determine whether surplus funds were available. However as stated in finding 1 of this report, we determined that the Authority's analysis contained errors. In May 2013, the Authority began implementing the offsets for the June 2013 housing assistance payments. However, the Authority started offsetting housing assistance payments using its flawed analysis.

**Comment 3** As stated in the report, the Authority lacked an understanding of HUD's requirements regarding its role in administering the program. The Authority believed that the notice did not apply to it. However, the Notice specifically stated that it applied to all projects that are subject to a new regulation project-based Section 8 housing assistance payments contract, including 883 properties. According to the Notice, the regulatory schemes codified in 24 CFR 880.104(a), 881.104(a), and 883.105(a) establishes the universe of projects to which the applicable new regulation applies. The Notice did not exclude properties in which State agencies were the contract administrators. Therefore, the Notice applied to both HUD-insured and non-insured properties. Further, the Authority entered into an annual contributions contract with HUD for all new-regulation projects and agreed to all of the contract terms, including the requirement to ensure that all of HUD's requirements would be followed. Further, the Authority entered into an annual contributions contract with HUD for all new-regulation

projects and agreed to all of the contract terms, including the requirement to ensure that all of HUD's requirements would be followed.

**Comment 4** We acknowledge that according to 24 CFR 883, the Authority determines whether a project has surplus project funds. However, the executed housing assistance payments contract requires that surplus project funds be deposited with the agency, mortgagee, or other agency approved depository in an interest bearing account. Further, the Authority has not provided the audit guidelines it uses to determine excess funds. As mentioned in comment 2, we determined that the Authority's analysis for determining surplus funds contained significant deficiencies. In addition, according to the Notice, the regulatory schemes codified in 24 CFR 880.104(a), 881.104(a), and 883.105(a) establishes the universe of projects to which the applicable new regulation applies. The Notice did not exclude properties in which State agencies were the contract administrators. Therefore, the Notice applied to HUD-insured and non-insured properties. Under part 883, the Authority is responsible for project development and for supervision of the development, management and maintenance functions of owners. However, the Authority's actions are subject to audit and review by HUD to assure compliance with Federal requirements and HUD's objectives.

In a letter from the Authority to HUD dated January 29, 2010, the Authority stated that funds remaining in the operating cash reserve constitute what are commonly called residual receipts. In addition, the Authority was not consistently following the policies as stated in its own comments. For instance, the owners of Program project numbers MI28H150193, MI33H150063, and MI28H150177, all received limited distribution payments before making deposits to their operating cash reserve. Further, the Authority's own regulatory agreements for the Program projects state that residual receipts should include all funds received by the mortgagor in connection with the operation of the project after (1) the mortgage note is paid, (2) all amount required are deposited into the replacement reserve, and (3) after all other project expenses have been paid. The Authority's definition of residual receipts in its regulatory agreements is consistent with HUD's definition of residual receipts.

**Comment 5** HUD Handbook 4350.1, REV-1, chapter 1, section 1-3 states that in carrying out its mission, HUD monitors and works with mortgagors, managing agents, mortgagees, subsidy contract administrators, and other clients to ensure compliance with the requirements of HUD's programs. Further, chapter 1 section 1-4, of the handbook also states that the Office of Multifamily Housing Management exercise responsibility toward the taxpayer as applicable by:

- C. Maximizing collections of all funds due HUD,
- D. Enforcing statutes and regulations, and
- E. Allocating, administering, and monitoring subsidy-based programs in a cost-effective manner.

The handbook further states that generally, all projects owned by non-profit mortgagors and all Section 236 and 221(d)(3) projects owned by limited distribution mortgagors as well as Section 8 new construction and substantial rehabilitation projects subject to the 1979 - 80 revised Section 8 regulations are required to establish a residual receipts account. The requirement for a residual receipts account is established by a regulatory agreement or a project-based subsidy contract such as Section 8 housing assistance payments.

**Comment 6** The audit report included statements made by HUD, which show agreement with our conclusions. However, these statements were not used to support the audit report. Therefore, we relied on HUD's regulations, Notices, Handbooks, Guidebooks, and other criteria related to the program in addition to the legally executed documents (between HUD and the Authority) to support our audit report. HUD regulations at 24 CFR 883, states that upon termination of the contracts, any excess project funds should be remitted to HUD. Therefore, the regulation clearly implies that HUD has ownership of excess or surplus project funds. The Notice states that the Department is setting forth the policy and procedures for the Department's use of new regulation residual receipts to offset housing assistance payments for projects subject to a new regulation project-based Section 8 program contract. The Notice applied to all projects that are subject to a new regulation project-based Section 8 program contracts that are subject to 24 CFR 880.205, 881.205, or 883.306. It did not exclude 883 properties managed for State agencies.

Instead, the Notice specifically stated that for projects subject to 24 CFR 883, in effect as of February 29, 1980, the State agency, rather than HUD, is entitled to make the determination that project funds are more than the amount needed and to require that the excess be deposited into an interest-bearing account to be used for project purposes, including the offset of housing assistance. Although the Notice permits the State agency to make the determination, the requirement that excess funds to be used to offset housing assistance is the purpose of the Notice. Further, the Authority entered into an annual contributions contract with HUD for all new-regulation projects and agreed to all of the contract terms, including the requirement to ensure that all of HUD's requirements would be followed.

HUD Handbook 4350.3 REV-1, chapter 1, section 4, states that subsidy contract administration involves a broad range of responsibilities, including program compliance functions to ensure that HUD-subsidized properties are serving eligible families at the correct level of assistance, and asset management functions to ensure the physical and financial health of HUD properties. HUD has primary responsibility for contract administration but has assigned portions of these responsibilities to other organizations that act as contract administrators for HUD. These contract administrators are generally housing agencies, such as State housing finance agencies or local housing authorities. Traditional contract administrators have been used for over 20 years and have annual contributions



contracts with HUD. Under their contracts, traditional contract administrators are responsible for asset management functions and housing assistance payments contract compliance and monitoring functions. They are paid a fee by HUD for their services. Further, HUD Handbook 4350.3 REV-1, chapter 25, section 1 states that generally, all projects owned by non-profit mortgagors and all Section 236 and 221(d)(3) projects owned by limited distribution mortgagors as well as Section 8 New Construction or Substantial Rehabilitation projects subject to the revised Section 8 regulations are required to establish a residual receipts account. The requirement for a residual receipts account is established by a regulatory agreement or a project-based subsidy contract such as Section 8 Housing Assistance Payments contract.

**Comment 7** The letter from HUD dated March 27, 2013, references a meeting between HUD and the Authority which occurred on January 20, 2013. The Authority presented its cash flows analysis to HUD and requested that HUD allow its alternate method of calculating residual receipts and not to hold the owners to the required retained balance of \$250 per unit. On February 21, 2013, HUD responded to the Authority's request stating that the Authority's proposed alternative method did not comply with the Notice and was therefore not approved. Further, the letter gave the Authority until March 7, 2013, to respond to allow the reduction of housing assistance payments to begin on April 1, 2013. The Authority failed to meet the April 1, 2013, date, therefore HUD stated it would start sending out recapture letters to owners for the May 2013 voucher submissions applicable to the June 2013 subsidy payments. The Authority failed to comply with the Notice until HUD sent out the recapture letters to the owners.

**Comment 8** The Authority asserts that of the \$31 million in surplus funds, more than \$6.8 million is not available to offset housing assistance payments. As stated in finding 1, the Authority requested to use more than \$6.4 million of residual receipts of two projects (contract numbers MI33H150039 and MI28H150181) to pay refinancing costs and reestablish the escrow accounts. However, in a letter, dated February 21, 2013, HUD denied the Authority's request to use project funds, including residual receipts, to refinance the Authority-held mortgages because it was not an eligible use of the residual receipts. For the remaining more than \$350,000, the agency projected negative operations. However, as mentioned in the audit report and comment 2, the agency's projected analysis contained significant errors. Therefore, the Authority should obtain HUD's approval for its revised analysis.

**Comment 9** HUD's memorandum, dated October 2, 2012, in response to question number 3 regarding the retained balance, states that if HUD has approved requests for the use of residual receipts accounts before the Notice was issued, the approval remains in place. Any requests made after the Notice must be denied. In addition, in response to question number 7 regarding the use of residual receipts, for a poorly scored Real Estate Assessment Center review, the owner must

receive written approval from the HUD field office before considering the use of monies in the residual receipts account. Therefore, we have determined that HUD approval would be needed for the disbursements of residual receipts that occurred after the Notice.

- Comment 10** HUD Handbook 4350.3 REV-1 CHG-3, chapter 1 section 5 states that Federal statutory program eligibility requirements cannot be overruled by State or local law. Further, the Authority did not provide documentation to support its assertions that the disbursements for the four projects were permitted, approved by HUD, or that the court order overruled the Federal statutory requirements.
- Comment 11** The Authority did not provide documentation to support that the funds were transferred from the replacement reserve account to the operating cash reserve (residual receipts) account.
- Comment 12** We amended the wording in our recommendation to request that repayment be from non-Federal funds to the appropriate escrow account, not to HUD.
- Comment 13** HUD's memorandum, dated October 2, 2012, states that items that have accrued must be paid from the retained balance. The Authority disbursed an accrued limited distribution to contract number MI33H150193. The portion of the limited distribution that exceeded contract number MI33H150193's retained balance was considered an inappropriate residual receipts disbursement.
- Comment 14** In section 2.1 of the contract, the term obligation is not referring to rights of parties. Instead, it is stating that neither HUD nor the housing finance agency must assume any (monetary) obligations beyond that provided in the HUD approved agreement and contract. Further the Authority's master agreement executed with HUD on September 30, 1980, section 0.4 states that the Authority agrees to comply, and to require owners to comply with the U. S. Housing Act of 1937 and all applicable regulations and requirements.
- Comment 15** The Inspector General Act of 1978, as amended, creates independent and investigative units, called Offices of Inspector General. The mission of the OIG, as spelled out in the Act, is to: (1) conduct and supervise independent and objective audits and investigations relating to agency programs and operations (2) promote economy, effectiveness, and efficiency within the agency, (3) prevent and detect fraud waste and abuse in agency programs, (4) review and make recommendation regarding existing and proposed legislation and regulations relating to agency programs and operations, and (5) to keep the agency and Congress fully and currently informed of problems in the agency programs and operations. As stated in the audit report, our objective was to determine whether the Authority administered its program for new-regulation projects in accordance with HUD's requirements. Specifically, we wanted to determine whether the Authority (1) applied program residual receipts to reduce or offset housing

assistance payments for new-regulation projects, (2) remitted excess or unused project funds to HUD upon termination of new-regulation contracts, and (3) appropriately maintained escrows for new-regulation projects.

In addition, 24 CFR 883.106 (c)(2) states that HUD will periodically monitor the activities of housing finance agencies participating under this part only with respect to Section 8 or other HUD programs. This monitoring is intended primarily to ensure that certifications submitted and projects operated under this part reflect appropriate compliance with Federal law and other requirements.

- Comment 16** As mentioned in the audit report, the Authority did not provide adequate documentation to support its determination of excess project funds. It also did not provide documentation to support its assertions that limiting project funds to \$250 per unit would be a detriment to its projects. Additionally, the projects' excess funds would be used to offset housing assistance over a period of time. Therefore, the Authority's assertions that the projects would be in default or have their utilities shut off are unfounded. Further, the recommendation in the report does not state that funds should be reimbursed to HUD, but used to offset future housing assistance. We contacted seven different HUD field offices and determined that seven different state housing agencies were complying with the Notice and using the \$250-per unit as the retained balance in offsetting residual receipts for new-regulation projects.
- Comment 17** As recommended in the audit report, the Authority should work with HUD to ensure the recommendations are addressed appropriately.
- Comment 18** HUD's regulations at 24 CFR 883.306(e) effective February 29, 1980, state that upon termination of the contract, any excess project funds must be remitted to HUD.
- Comment 19** We agree with the Authority's calculation of excess funds for the project number MI28H150160. We have updated the report and recommendation to reflect the corrected amount. However, the Authority did not provide a copy of the wire transfer to the United States Treasury.
- Comment 20** The Authority did not provide documentation to support its calculation of surplus funds for the MI33H150050 project, nor did it provide a copy of the wire transfer to the United States Treasury.
- Comment 21** As stated in the audit report, according to the Authority, its loan agreement with the owner allowed the replacement reserves to be applied to the defaulted mortgage. However, HUD did not waive the requirement for the Authority to remit unused or excess project funds. Further, the Authority's attachments contained a response from HUD stating that HUD required additional information from the Authority.

**Comment 22** HUD requires the excess project funds to be remitted on the contract termination date, not the OIG. In a letter to the Authority dated May 25, 2010, HUD stated that funds remaining in the operating reserve cash (residual receipts) account on the contract termination date, excluding funds that HUD has determined are not excess project funds, as can be clearly demonstrated as such by the Authority, shall be remitted to HUD on the contract termination date. Further, HUD's regulations at 24 CFR 883.306(e) effective February 29, 1980, state that upon termination of the Contract, any excess project funds must be remitted to HUD.

**Comment 23** As recommended in this report, HUD will ensure that the Authority's agreements for new-regulation projects comply with HUD's regulations.

**Comment 24** For project number MI28H150160, the Authority failed to remit the excess project funds after the contract termination for more than 2,192 days.

**Comment 25** As stated in the audit report, the Authority inappropriately disbursed replacement reserves. The replacement reserve is required to be established by the program contract, to defray the cost of the replacement of major depreciable items. The contract between the Authority and the owner requires the establishment of the replacement reserve. Also, according to section 2.6(d)(1) of the Authority's contract with the owner, the owner is required to establish and maintain the reserve account, at the direction of the Authority to aid in funding extraordinary maintenance and repair and replacement of capital items. Section 2.6 (c) (1) states that project funds must be used for the benefit of the project, to make mortgage payments, make required deposits to the replacement reserve, and to provide limited distributions to the owner. The contract does not state that funds accumulated for the extraordinary maintenance and repair and replacement of capital items can be used for paying owner income. Further, the section 2.6 (d) (1) (ii) states that if the replacement reserve achieves a level sufficient to meet the projected requirements, the rate of deposit to the reserve may be reduced with the Authority's approval.

**Comment 26** The Authority did not provide documentation to support that all of the projects' replacement reserves needs were addressed, that new replacement reserves were established, or that the replacement reserves distributed to owners were excess project funds.

**Comment 27** HUD will determine whether the Authority's updated procedures meet HUD's requirements.

**Comment 28** We disagree with the Authority's interpretation that HUD OIG was sent out to audit as a response to the Authority's correspondence with HUD expressing its disagreement with the Notice. HUD and the Authority have been in constant discussions regarding the ownership of program escrows from 2008 forward.

OIG was asked by HUD management to audit the Authority to ensure compliance with the Notice.

**Comment 29** We commend the Authority for its willingness to cooperate with HUD in the administration of its programs.

## Appendix C

### FEDERAL AND THE AUTHORITY'S REQUIREMENTS

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#### Finding 1

Section 8(z)(1) of the United States Housing Act of 1937, as amended, states that HUD's Secretary may reuse any budget authority, in whole or part, that is recaptured on account of termination of a housing assistance payments contract.

HUD's regulations at 24 CFR 880.601(e) state that project funds must be used for the benefit of the project, to make required deposits to the replacement reserve, and to provide distributions to the owner in accordance with HUD's regulations. Any remaining project funds must be deposited with the Authority, other lender, or other Authority-approved depository in an interest-bearing account.

HUD's regulations at 24 CFR 883.306(b) state that for the life of the contract, project funds may be distributed only to profit-motivated owners at the end of each fiscal year of project operation following the effective date of the contract and after all project expenses have been paid or funds have been set aside for payment and all reserve requirements have been met.

HUD's regulations at 24 CFR 883.306(d) state that any shortfall in return may be made up from surplus project funds in future years.

HUD's regulations at 24 CFR 883.306(e) state that if the Authority determines at any time that surplus project funds are more than the amount needed for project operations, reserve requirements, and permitted distributions, the Authority may require the excess to be placed in a separate account to be used to reduce housing assistance payments or for other project purposes.

Part I, section 1.2, of the annual contributions contract for all new-regulation projects, form HUD-52643B, version 8-80, states, "The Authority is authorized to (a) enter into an Agreement, (b) enter into Contract, (c) make housing assistance payments on behalf of Families, and (d) take other necessary actions, all in accordance with the forms, conditions, regulations, and requirements prescribed or approved by HUD."

Part II, paragraph 2.6(c)(1), of the new-regulation contract, version 8-80, states that to the extent the Authority determines that project funds are more than needed for making mortgage payments, paying operating expenses, making required deposits to the replacement reserve in accordance with HUD's regulations, and providing distributions to the owner as provided in HUD's regulations, the surplus project funds must be deposited with the Authority, lender, or other Authority-approved depository in an interest-bearing account.

Housing Notice H-2012-14, section V.A., states that to the extent that Residual Receipts are available at a new regulation project, Owners are allowed an initial reserve (“Retained Balance”) in an amount equivalent to \$250 per unit to use for project purposes. HUD will consider approving requests for releases from the account in accordance with the outstanding procedures found in HUD Handbook 4350.1, Multifamily Asset Management and Project Servicing, Chapter 25, “Residual Receipts,” paragraph 25-9.

Housing Notice H-2012-14, section V.C., states that residual receipts account balances in excess of \$250 per revenue-generating unit must be applied monthly to offset Section 8 housing assistance payments up to the full amount of the monthly subsidy request, depending upon the amount of residual receipts available for the offset.

HUD’s memorandum, dated October 2, 2012, in answer to question number 4 under the section, Calculating the Balance of Residual Receipts Account, states that the \$250 per unit of retained balance applied to the number of units is the number of revenue-producing units in the project, regardless of units under the Section 8 contract or the total number of units in the project.

## **Finding 2**

HUD’s regulations at 24 CFR 883.306(e) state that upon termination of the housing assistance payments contract, any excess project funds must be remitted to HUD.

Part II, section 2.6(c)(1), of the new-regulation contract, version 8-80, states that upon termination of the housing assistance payments contract, any excess funds must be remitted to HUD.

## **Finding 3**

HUD’s regulations at 24 CFR 883.306(e) state that upon termination of the housing assistance payments contract, any excess project funds must be remitted to HUD.

HUD’s regulations at 24 CFR 880.602(a) state that a replacement reserve must be established and maintained in an interest-bearing account to aid in funding extraordinary maintenance and repair and replacement of capital items.

Part II, section 2.6(c)(1), of the new-regulation contract, version 8-80, states that upon termination of the housing assistance payments contract, any excess funds must be remitted to HUD.

Part II, section 2.6(d)(1), of the new-regulation contract, version 8-80, states that the project owner must establish and maintain, at the direction of the Authority, a replacement reserve in an interest-bearing account to aid in funding extraordinary maintenance and repair and replacement of capital items.

The Authority's reserve for replacement policy, revised April 2013, states that the Authority's loan agreements between projects and the Authority require the establishment and maintenance of the Authority's held replacement reserve fund. The replacement reserve fund is primarily designed to defray the cost of the replacement of major depreciable items provided for in the original mortgage. Further, upon payment in full of the mortgage loan, the disbursement of excess funds is governed by the legal documents and applicable law. The projects with replacement reserve needs amounts must resolve the need amount before owner's income can be disbursed.



## Appendix D

### PROGRAM RESIDUAL RECEIPTS AVAILABLE FOR REDUCTION OR OFFSET OF HOUSING ASSISTANCE PAYMENTS AS OF MAY 31, 2013

Number	Contract number	Available residual receipts	Disbursements above retained balance	Unnecessary subsidy received
1	MI28H150189	\$16,652,079	\$0	\$681,447
2	MI28H150183	5,853,755	318,063	766,024
3	MI28H150181	5,365,492	0	755,983
4	MI33H150039	1,213,614	0	758,347
5	MI28H150177	619,355	0	396,913
6	MI33H150065	457,294	0	257,116
7	MI28H150223	319,212	19,703	333,508
8	MI33H150056	281,046	0	239,243
9	MI28H150190	190,107	0	127,552
10	MI28H150204	88,093	65,510	211,993
11	MI33H150080	48,052	0	22,318
12	MI33H150079	39,782	0	26,624
13	MI33H150051	19,142	0	16,137
14	MI28H150080	1,325	2,623	4,308
15	MI33H150076	129	21,716	1,794
16	MI28H150193	0	1,189	0
17	MI28H150202	0	0	21,916
18	MI28H150206	0	0	8,936
<b>Totals</b>		<b>\$31,148,477</b>	<b>\$428,804</b>	<b>\$4,630,159</b>