OFFICE OF AUDIT
REGION 2
NEW YORK-NEW JERSEY

U.S. Department of Housing and Urban Development, Office of Multifamily Housing Programs, Washington, DC

HUD's Oversight of Section 202 Multifamily Housing Project Refinances

2014-NY-0001 FEBRUARY 19, 2014

Issue Date: February 19, 2014

Audit Report Number: 2014-NY-0001

TO: Mark Van Kirk
Director, Office of Multifamily Asset Management, HTG

//SIGNED//

FROM: Edgar Moore
Regional Inspector General for Audit, New York-New Jersey Region, 2AGA

SUBJECT: HUD Did Not Provide Effective Oversight of Section 202 Multifamily Project Refinances

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), final results of our review of HUD's oversight of Section 202 multifamily housing project refinances.

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 8L, 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 (212) 264-4174.

February 19, 2014

HUD Did Not Provide Effective Oversight of Section 202 Multifamily Housing Project Refinances

Highlights

Audit Report 2014-NY-0001

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) oversight of Section 202 multifamily housing project refinances as part of the Inspector General's goal of promoting fiscal responsibility and financial accountability. Our objective was to determine whether HUD had adequate controls to ensure that Section 202 refinancing was conducted in an effective and efficient manner.

What We Recommend

We recommend that HUD (1) develop and implement consistent nationwide policies for oversight and monitoring of debt service savings, thereby ensuring that at least $21 million per year is used to benefit tenants or reduce housing assistance payments; (2) direct field offices to account for and analyze debt service savings and when possible, require the savings to be used to offset housing assistance payments; and (3) implement procedures to ensure that refinancings comply with the requirement to generate positive debt service savings.

What We Found

HUD did not have adequate controls to ensure that all Section 202 refinancing resulted in economical and efficient outcomes. Specifically, (1) HUD did not ensure that at least half the debt service savings that resulted from refinancing were used to benefit tenants or reduce housing assistance payments, (2) consistent accountability for the debt service savings was not always maintained, and (3) some refinancing were processed for projects that had negative debt service savings, which resulted in higher debt service costs than before the refinancing. These deficiencies were due to HUD's lack of adequate oversight and inconsistent nationwide policy implementation regarding debt service savings realized from Section 202 refinancing activities. As a result, millions of dollars in debt service savings were not properly accounted for and available, the savings may not have been used to benefit tenants or for the reduction of housing assistance payments, and some refinanced projects ended up costing HUD additional housing assistance payments because of the additional cost for debt service.

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BACKGROUND AND OBJECTIVE

The U.S. Department of Housing and Urban Development's (HUD) Office of Multifamily Housing Programs is responsible for the overall management, development, direction, and administration of HUD's multifamily housing programs. Within the Office of Multifamily Housing Programs, the Office of Asset Management is responsible for the oversight of multifamily project assets after their development.

Under the Office of Asset Management, the Field Asset Management Division is responsible for matters affecting the condition and management of the properties; dealing with property ownership and sales issues; and processing requests for refinancing of Federal Housing Administration (FHA)-insured mortgages, HUD-held mortgages, and Section 202 direct loans.[1]

Public Law 106-569, dated December 27, 2000, governs the refinancing of Section 202 projects into Federal Housing Administration (FHA) insurance under section 223(f). HUD Notice H 2002-16 implemented the public law and indicated that at least 50 percent of debt service savings had to be used for the benefit of the tenants or rehabilitation or modernization of the project. Therefore, debt service savings realized from refinancing for longer terms at reduced interest rates could have been used to reduce rents or housing assistance payments.

Public Law 111-372, dated January 4, 2011, was implemented by Notice H 2012-8 on May 4, 2012. The major changes in the new policy included eliminating the requirement to escrow debt service savings and the requirement that at least 50 percent of the annual savings be made available for specific purposes benefiting the tenants.

Our audit objective was to determine whether HUD had adequate controls to ensure that Section 202 refinancing was conducted in an effective and efficient manner.[2]

[1] Section 202 direct loans are long-term loans made by HUD to nonprofit borrower corporations formed to provide rental assistance for elderly and handicapped persons. As such, these HUD loans do not have mortgage insurance.

[2] Standards for Internal Control in the Federal Government, published by the U.S. Government Accountability Office in 1999, definition and objectives section, states that internal controls should provide reasonable assurance that the objectives of the agency are achieved in several categories, including effectiveness and efficiency of operations and the use of the entity's resources.

RESULTS OF AUDIT

Finding: HUD Did Not Provide Effective Oversight of Section 202 Multifamily Project Refinances

HUD did not have adequate controls to ensure that all Section 202 refinancing resulted in economical and efficient outcomes. Specifically, (1) HUD did not ensure that at least half of the debt service savings that resulted from the refinancing were used to benefit tenants or reduce housing assistance payments, (2) consistent accountability for the debt service savings was not always maintained, and (3) some refinancing were processed for projects that had negative debt service savings, which resulted in higher debt service costs than before the refinancing. These deficiencies were due to HUD's lack of adequate oversight and inconsistent nationwide policy implementation regarding debt service savings realized from Section 202 refinancing activities. As a result, millions of dollars in debt service savings were not properly accounted for, available savings may not have been used to benefit tenants or for the reduction of housing assistance payments, and some refinanced projects ended up costing HUD additional housing assistance payments because of the additional costs for debt service.

Fifty Percent of Debt Service Savings Were Not Always Used To Benefit Tenants or Reduce Housing Assistance Payments

HUD did not have effective oversight and monitoring to ensure that all Section 202 refinancings resulted in economical and efficient outcomes. Many projects realized significant annual budget savings when they refinanced their Section 202 loans and obtained a new FHA-insured loan. In addition, many projects not only benefited from huge increases in cashflow from debt savings, but continued to receive substantial rent increases. Thus, HUD did not have an effective strategy for realizing possible savings of housing assistance payment subsidies from the refinancings. Verification of project records at three field offices revealed that HUD had not implemented procedures to ensure that debt service savings were used to benefit tenants or reduce housing assistance payments.

The public law provides that the HUD Secretary must make available at least 50 percent of the annual savings resulting from reduced Section 8 or other rental housing assistance contracts in a manner that is advantageous to the tenants, including reducing the rents of the unassisted tenants in a prorata sharing of the savings from the refinancing. Therefore, the public law implies that annual savings in debt service costs from the refinancing would result in lower costs for

Section 8 and housing assistance, which should be used to benefit tenants. Despite the public law's allowance for debt service savings to reduce or offset housing assistance and thus save millions of dollars in housing subsidies, there was no mechanism to ensure that this was done. Using computer-assisted audit techniques, we extracted information on Section 202 projects that had been refinaced from HUD's iREMS (Integrated Real Estate Management System). We calculated that for 971 Section 202 projects refinanced since 2002, there was a total of at least $42.1 million in annual debt service savings.

Therefore, at least half of this amount, or $21 million per year, could and should have been used to benefit tenants and for future reductions in the housing assistance payments provided to these projects. The total debt service savings over the years for projects refinanced before 2012 are calculated to be at least $183.3 million, and a significant amount of these funds could have been available to reduce housing assistance payments or offset rent increases.

HUD headquarters officials concurred with our concern that under the old policy, projects accumulated large debt savings account balances despite having agreed to use the funds for items eligible under that policy. HUD headquarters officials indicated that they would meet on this issue and planned to provide guidance to the field offices on this matter. HUD headquarters staff also wanted to ensure that all HUD field offices addressed this issue consistently. Under the new May 2012 policy, HUD officials believed that the debt savings would be better addressed since the savings would become part of the budget-based rent calculations.

Consistent Accountability for Debt Service Savings Was Not Maintained

HUD did not implement consistent and effective nationwide policies and procedures for tracking debt service savings. For the three field offices reviewed, each office administered the savings in a different manner. For example, one field office required projects to escrow the savings while not reducing the costs, two field offices did not properly account for and track the savings, and one field office allowed refinancings with negative debt service savings. As a result, there was a lack of control over and inconsistent accountability for the actual and planned uses of the funds.

The results of our audit work at the three HUD field offices are described below.

<u>Buffalo, NY, HUD Multifamily Office</u>

We examined and analyzed data from all Buffalo office Section 202 projects that had been refinanced into FHA insurance since 2002. There were 39 such projects processed under Public Law 106-569 and HUD Notice H 2002-16. In addition, the Buffalo office had 19 projects that were in the "pipeline" at the time of our fieldwork, being processed under the new Public Law 111-372 and HUD Notice H 2012-8, dated May 4, 2012.

Projects Required To Escrow Debt Service Savings

The Buffalo office had 39 Section 202 direct loans that refinanced and were required by the Buffalo office to escrow the debt service savings. The projects would then need to request HUD approval to draw down and use the funds. For these projects, HUD officials informed us that the annual debt service savings were more than $1.8 million. The balance in the debt savings accounts as of November 2012 was more than $3 million. However, it appeared that these funds were not needed by the projects for current or operational needs as they were available to be drawn down, much like in a reserve for replacement account. Many projects had plans to use the debt savings but sometimes did not follow the plan, providing further evidence that the debt savings were not needed by the projects. Therefore, HUD needs to address this issue as the more than $3 million in unused debt savings could be put to better use if HUD follows the public law by offsetting housing assistance payments with the savings.

The following are two examples of projects refinanced from the Buffalo office.

Project Number 014-11145

This project is a 40-unit subsidized Section 202 project that refinanced in 2006. The Buffalo office calculated the annual debt service savings to be $32,400 per year. Rather than offsetting housing assistance payments with a portion of the savings, HUD required the project to deposit the entire $32,400 into a debt service savings escrow account. HUD also required the project to submit a 5-year plan for the proposed uses of the escrowed debt savings. However, the owners did not follow the 5-year plan and used only a small portion of the debt savings for items that appeared to be eligible under Public Law 106-569.

Consequently, as of February 2013, the escrow account contained more than $139,000 in unused debt service savings. These funds amounted to excess housing assistance payment subsidies that were not needed by the project, but HUD had no mechanism for using these funds for a housing assistance payment offset. In addition, the project had a reserve for replacement balance of more than $273,000. Finally, the project continued to receive large rent increases to cover operating costs, including a 7.3 percent rent increase in 2009.

Project Number 014-11162

This project is a 151-unit subsidized Section 202 project that refinanced in 2009. The Buffalo office calculated the annual debt service savings to be $168,341 per year. These funds were also deposited into a debt service savings escrow account. This particular project had not used any of the savings for eligible costs, despite having a 5-year plan to use all of the funds primarily on remodeling the units, including the replacement of refrigerators and stoves. The project had more than $561,000 in debt savings in an escrow account as of March 12, 2013. However, although the project had available debt service savings, it continued to receive rent increases, with a 2.4 percent rent increase in June 2009 and a 4 percent rent increase in June 2010.

Buffalo officials did not receive updated policy direction regarding how to use the debt savings reserves. Therefore, HUD needs to explore the possibility of saving these funds by using the reserves to offset monthly housing assistance costs. Collectively, at the Buffalo office, the 39 projects were required to escrow more than $1.8 million per year, and the balance in the debt savings accounts was more than $3 million as of Novermber 2012. Since these funds did not appear to have been needed by the projects for current or operational needs, HUD needs to address how to recapture these unnecessary funds and save housing assistance payment subsidies and develop a plan for how to effectively use the annual $1.8 million in debt savings that continues to accrue.

HUD Buffalo Pipeline Projects Showing Debt Savings

For the 19 Section 202 projects in the pipeline that were being processed under Public Law 111-372, or the "new," policy, the Buffalo office did not have the projects maintain escrows for debt savings as this was not required. HUD staff calculated the annual debt savings for these 19 projects to be $625,293. This amount could be available for a reduction in housing assistance payments or rents since (as proven under the old policy) projects were able to save the total debt savings in escrow accounts and operate and pay their costs without using the debt savings. In addition, most of the projects had adequate reserve for replacement balances and would not appear to need the funds for replacement since noncritical repairs were made with loan proceeds at the time of FHA closing.

Pittsburgh, PA, Multifamily Office

The Pittsburgh office provided us a listing of 58 Section 202 projects that were refinanced from 2003 through November 30, 2012. All 58 projects generated annual debt service savings as required by the public law, amounting to more than $2 million per year, collectively.

Pittsburgh officials did not properly ensure that the debt service savings from the refinances were accounted for and used as intended by the public law. While they required, in writing, the projects to deposit the debt service savings into their respective residual receipts accounts, the balance in the accounts was not tracked or controlled. The office acknowledged that the accounts could contain surplus cash in addition to the debt service savings.

The Pittsburgh office then made the projects request approval for the use of residual receipts. However, from 2003 through 2012, many of the projects accumulated large balances in their residual receipts accounts. While the Pittsburgh office required the projects to submit a form HUD-9250 to release funds from their residual receipts accounts, the office had no record of the uses or balances of debt savings at each project.

We calculated that in the years since the respective closings of refinances, the Pittsburgh Section 202 projects had generated at least $9.8 million in annual debt service savings[3]. These are funds that technically either could have been used for housing assistance payment offsets or should have been tracked for other allowable uses.

Below is an example of a Section 202 project refinanced by the Pittsburgh office.

<u>Project Number 033-11072</u>

This project is a 50-unit subsidized Section 202 project that refinanced in 2007. The Pittsburgh office calculated the annual debt service savings to be $66,698. It sent the project owner a letter requiring that the debt savings of $66,698 per year be deposited into the project's residual receipts account. A review of iREMS showed that $66,698 (annual debt service savings) was deposited as required into the residual receipts account. However, the Pittsburgh office did not have procedures in place to ensure that uses of debt savings from the residual receipts account were (at least 50 percent) to benefit tenants as required under the public law for Section 202 refinance transactions. Thus, by the end of 2012, this project had accumulated more than $330,000 in its residual receipts account, indicating that most of the annual debt savings remained unused.

According to the new HUD policy, under Notice H 2012-14, entitled "Use of New Regulation, Section 8 Housing Assistance Payments (HAP) Contracts Residual Receipts to Offset Project-Based Section 8 Housing Assistance Payments," the Pittsburgh office had recently started making housing assistance payment offsets from owners' residual receipts accounts. This change was based on the HUD policy of not maintaining more than $250 per unit in the residual receipts account. As a result, in December 2012, HUD officials offset a

[3] The total debt service savings were calculated by multiplying the annual debt service savings for each refinanced project by the number of years since the closing for the refinancing.

scheduled housing assistance payment by taking $34,778 from the residual receipts account, based upon the new HUD policy of using excess residual receipts for housing assistance payment offsets.

Pittsburgh officials confirmed that these housing assistance payment offsets occurred at projects that refinanced before the new policy was in effect and that these residual receipts consisted primarily of debt service savings at many projects. They informed us that they would continue to offset the monthly housing assistance payments for this project from residual receipts. Pittsburgh officials also offset housing assistance payments at other projects with residual receipt balances that might contain large amounts of debt service savings. HUD needs to look at this issue nationally to ensure that housing assistance payments are offset in this manner by all field offices and document how much of the excess residual receipts is from debt savings.

Detroit, MI, Multifamily Office

The Detroit office refinanced 78 Section 202 projects into FHA insurance from 2003 through November 30, 2012. While most of the projects had a positive annual debt savings as required by the pubic law, the Detroit office processed at least 12 projects that resulted in negative annual debt savings; that is, the refinancing resulted in a higher debt sevice payment and a need for additional housing assistance payment subsidies.

For the projects with debt service savings, the Detroit office did not execute debt service savings agreements or have the projects escrow the savings since this was not required by the notice. However, we asked Detroit officials how the office tracked the use of debt service savings for compliance with the uses under the public law and found that the Detroit office did not track the debt savings for the projects.

We calculated that more than $14.3 million in debt service savings[4] related to 78 projects that were refinanced over an 8-year period had not been accounted for by the Detroit office and represented funds that could be put to better use if they were used to offset increases in housing assistance payments.

We tested 6 of the 78 projects during our site visit. An example is described below.

Project Number 044-11105

This project is a 146-unit subsidized Section 202 project that refinanced in 2006. The project had significant debt savings as a result of the refinancing. The Detroit

[4] See footnote 3 for computation method.

office, at our request, calculated the annual debt service savings to be $98,823. However, Detroit officials informed us that the office did not track the uses of debt savings but, rather, that debt savings flowed to residual receipts. Although the project had to request approval from HUD for the use of residual receipts, there was no assurance that the funds would be used to benefit tenants or reduce housing assistance payments.

We calculated that the project had received at least $592,940 in extra funds from the debt savings since the refinance date. Yet the project had only $82,514 in its residual receipts account as of December 31, 2012. This means that $510,426 in debt savings was expended without accountability regarding the use of the funds. Further, in addition to the extra nearly $100,000 in available funding per year, the project had been approved for rent increases amounting to 7.4 percent since the date of refinance, costing even more in housing assistance payment subsidies.

Some Refinanced Projects Resulted in Negative Debt Service Savings

HUD's Detroit office refinanced at least 12 Section 202 projects that had negative annual debt service savings, although the public law did not allow for this until the 2011 amendment and HUD implemented the change with a May 2012 housing notice. The 2000 Public Law 106-569 (American Homeownership and Economic Opportunity Act), Section 811, Prepayment and Refinancing, paragraph (a)(2), provides that "the prepayment may involve the refinancing of the loan if such refinancing results in a lower interest rate on the principal of the loan for the project and in reductions in debt service related to such loan." The 2011 Public Law 111-372, Section 201, amended the cited 2000 public law and indicated that refinancing is authorized with negative debt service savings only in cases in which a project assisted with a loan under Section 202 carries an intererst rate of 6 percent or lower. In addition, a data search of iREMS showed that HUD processed at least 160 FHA mortgages from 2002 through 2011 that had an increase in debt service payments from their Section 202 payments; that is, negative debt savings. We calculated that these FHA loans cost the taxpayers at least $19 million per year in additional housing assistance payment subsidies. As a result, HUD needs to implement procedures to ensure that all future Section 202 refinancings comply with the requirement to generate positive debt service savings or the limited exception to this requirement related to 6 percent or lower interest rates.

Conclusion

HUD did not have effective oversight and monitoring to ensure that all Section 202 refinancings resulted in economical and efficient outcomes. Half of the debt services savings were not always used to benefit tenants or reduce housing assistance payments, consistent accountability for the debt service savings was not always maintained, and some refinancings were processed for projects that had negative debt service savings, which resulted in higher debt service costs than before the refinancing. As a result, millions of dollars in debt service savings were not properly accounted for, available debt service savings was not always used to benefit tenants or for the reduction of housing assistance payments, and some refinanced projects ended up costing HUD additional housing assistance payments because of the additional costs for debt service. We attribute this condition to HUD's lack of adequate oversight and inconsistent nationwide policy implementation regarding debt service savings realized from Section 202 refinancing activities.

Recommendations

We recommend that the Director, Office of Multifamily Asset Management,

1A Clarify, develop or issue policies and procedures as needed to ensure that the calculation and use of any Section 202/223(f) refinancing savings is to benefit project purposes or reduce housing assistance payments and is supported by appropriate monitoring and accounting for these savings, thus resulting in funds to be put to a better use of $21,097,996.

1B Require that each Hub or field office review its refinanced Section 202/223(f) projects for debt service savings amounts, utilizing data provided from this audit for possible additional debt service savings. Where legally possible each Hub or field office should identify, account for by project, and use these amounts for current and future opportunities benefiting tenants or to fund reductions in housing assistance payments.

1C. Implement procedures to ensure that all future Section 202 refinancings comply with the requirement to generate positive debt service savings or the limited exception to this requirement related to 6 percent or lower interest rates.

SCOPE AND METHODOLOGY

Our audit period covered January 1 through December 31, 2012. We conducted our fieldwork at the HUD multifamily program centers in Buffalo, NY, and Pittsburgh, PA, and the Detroit, MI, hub between October 2012 and July 2013.

To accomplish our objective, we

- Reviewed applicable laws and regulations, policies and procedures, HUD notices and guidance, and internal controls relating to Section 202 refinancing activities.

- Obtained, reviewed, and analyzed HUD multifamily data for Section 202 refinanced projects.

- Interviewed HUD headquarters and field office management and staff responsible for oversight of Section 202 project refinancing.

- Obtained, reviewed, and analyzed hardcopy and electronic project documentation nationwide and at the three program centers and hubs visited during the audit.

We relied on computer-processed data for providing background information on the Section 202 projects that were refinanced during our audit period. We performed a minimal level of testing and found the data to be adequate for our purposes.

We used computer assisted audit techniques to extract and analyze information on Section 202 projects that had been refinaced from iREMS and also reviewed data on all Section 202 refinancing transactions nationwide from 2003 through 2012 to determine the annual and cumulative amounts of debt service savings, we conducted detailed testing of all Section 202 refinancing transactions at three field offices that had large volumes of project refinancing from 2003 through 2012, including Buffalo, NY, Pittsburgh PA, and Detroit MI.

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

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Compliance with laws and regulations – Policies and procedures that management has implemented to reasonably ensure that resource use is consistent with laws and regulations.

- Safeguarding resources – Policies and procedures that management has implemented to reasonably ensure that resources are safeguarded against waste, loss, and misuse.

- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

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 Deficiencies

Based on our review, we believe that the following items are significant deficiencies:

- Program operations – HUD did not have adequate controls to ensure that program objectives would be met as the three field offices reviewed administered debt service savings resulting from the refinancings differently, thereby reducing the likelihood that program objectives would be attained (see finding).

- Compliance with laws and regulations – HUD had not implemented adequate controls to ensure that the use of debt service savings was consistent with laws and regulations as the savings may not have been used to benefit tenants or reduce housing assistance payments (see finding).

- Safeguarding resources – HUD had not implemented adequate controls to ensure that debt service savings were adequately safeguarded against waste, loss, and misuse as the savings were not tracked or properly accounted for at two of the field offices (see finding).

APPENDIXES

Appendix A

SCHEDULE OF FUNDS TO BE PUT TO BETTER USE

Recommendation number	Funds to be put to better use 1/
1A	$21,097,996

1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an Office of Inspector General (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 HUD implements our recommendation, it will ensure that the annual debt service savings of more than $21 million will be properly safeguarded and used as intended for allowable purposes to benefit the projects, tenants, or both and reduce or offset future housing assistance payments.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

OFFICE OF HOUSING

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

JAN 2 3 2014

MEMORANDUM FOR: Edgar Moore, Regional Inspector General for Audit, New York Multifamily Hub, 2AGA

FROM: Mark B. Van Kirk, Director, Office of Asset Management, HTG

SUBJECT: Draft Audit Report – HUD's Oversight of Section 202 Multifamily Housing Project Refinances

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

Comment 1

Specific comments follow, but we wanted to start with general observations. The original objectives of the audit survey stated that the survey was, "to determine whether HUD (1) is taking adequate measures to ensure that insured multifamily projects remain financially viable, (2) can better manage multifamily portfolios to ensure that more funding is available for additional quality, affordable rental homes, and (3) is taking advantage of low interest rates and having projects refinance higher rate debts." Following the Exit Conference for this audit you provided to us a list of over 900 projects which were refinanced during the period reviewed in the audit. It is hard to get a sense from your draft audit report how this programmatic effort to refinance eligible projects enhanced the viability of our projects at a more economical cost to HUD, because the focus of the draft audit report, as evidenced by the language used, is on where there were performance problems such as is summarized by the overall Subject descriptor, "HUD Did Not Provide Effective Oversight of Section 202 Multifamily Project Refinances."

Comment 2

The Office of Asset Management (OAM), with assistance from the field, is reviewing the list of projects from your audit and appreciates you providing it to us on December 19, 2013. The OAM is not an accounting office, and documentation of the impact of the program change which generated the potential savings from the 202 refinancing effort is not readily available. However, because of another programmatic effort to use Residual Receipts (RR), in part to offset the cost of Housing Assistance Payments (HAP), we were able to determine that over $37 million of RR funds were used from projects involved in this audit to fund the HAP. It should be noted that another OIG audit, 2007-KC-0002, titled HUD Can Improve Its Use of Residual Receipts to Reduce Housing Assistance Payments", similarly suggested this course of action. Since the OAM began tracking this information in October 2012, a total of over $159 million through the end of Fiscal Year (FY) 2013, and $37 million to date in FY 2014 of project RR have been used to fund the HAP. The

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ongoing efforts of the OAM and the Office of Multifamily Housing Programs to use scarce budget resources should be reflected to keep the discussion of potential available resources reported on page 5 and page 16 in context. Our Housing Notice H 2012-14 made this possible.

Comment 3

While you mentioned on page 8 of the draft the use of HUD-9250 regarding the release of funds from RR, the availability of funds and their accumulation for use by the project or to offset HAP in your recommendations to the field office, you promote the use of a separate account for the debt service savings (DSS) using a Debt Service Savings Escrow account. What you propose is a bookkeeping effort to track information. However, this is based on an understanding of Public Law (P. L.) 106-569 that we believe is not accurate. From our reading of your draft report, the audit has the view that law per P. L. 106-569 implied (see page 4-5 conclusion) that DSS should be used to offset the HAP. This is contradictory to the way DSS were achieved, through using the debt service from the original 202 Direct Loan in the Section 8 budget determinations, until the law was changed in 2010 with guidance following implementing the change via Housing Notice H 2012-8. Consequently, it seems that prior to the law change, not much would be available as noted in the funds put to better use discussion.

Comment4

Also, how the new law operates to manage DSS is not correctly reflected in the reporting because the HAP are reduced when the Section 8 HAP budget is calculated using the debt service of the new financing. On page 7 of the draft, the second to last paragraph is incorrect. Prepayments processed under the new Notice thus used reduce the need and there is no DSS to track.

In addition to these general comments, we have the following specific comments regarding the report and the data you sent to us. The audit rests on the testing at these three Hubs. Since you visited three Hubs, we circulated the data to them for review. While we acknowledge that bookkeeping for the DSS may have varied between offices, we need to make the following additional points:

Comment 5

- The Buffalo Multifamily Program Center used DSS escrow accounts and when the new Housing Notice H 2012-8 was issued they attempted to eliminate these accounts and start relying solely on RR accounts. However, because of business agreements with the project owners, the closing of existing DSS escrow accounts cannot be achieved without owners' consent and, therefore, old DSS amounts may not be usable.

Comment 6

- The Pittsburgh Multifamily Program Center emphasized the control of the HUD-9250 process to manage funds in RR which accumulate because of DSS. They emphasized that there is no requirement to have used funds as they accrued.

Comment 7

Comment 8

- The Detroit Multifamily Hub emphasized that DSS led to lower rental increases and also emphasized the inability given existing business agreements to retroactively apply policy from Housing Notice H 2012-8. Also, the Detroit Hub's review of the data from your test at their office led them to note for the 12 projects that had negative DSS that about half of them had rent savings. The rest had mitigating considerations which would explain why the negative DSS occurred. We can provide this information to you outside of this memorandum, but the point would be

Ref to OIG Evaluation **Auditee Comments**

that the OIG observation in this area needs to consider the explanations provided for the data reviewed.

Therefore, as a result of our review of the draft with respect to the recommendations you proposed in the draft, we suggest the following changes in wording to recommendations which we would agree with:

Comment 9

- Recommendations 1A and 1E both deal with policy and procedures which focus on aspects of the calculation and use of DSS from refinanced projects. Any policy and procedures update would ultimately address this as a single topic. Also, since policies and procedures issued by the OAM apply nationwide, use of the terms consistent and nationwide are not needed. Therefore, we suggest that recommendations 1A and 1E should be combined into one recommendation to read, "Clarify, develop or issue policies and procedures, as needed, to ensure the calculation and use of any Section 202/223(f) refinancing to generate debt service savings to benefit project purposes or reduce housing assistance payments supported by appropriate monitoring and accounting for these savings.

Comment 10

- Recommendations 1B, 1C, and 1D deal with inconsistencies and performance issues identified at the three field offices you visited, and advocate the use of DSS accounts. Policy and procedure originates in the OAM and would be addressed by the management plan responding to the recommendation for issuing as needed policy and procedure in the suggested combined recommendation discussed above. Recommendations 1B, 1C and 1D, therefore, can be combined into one recommendation which goes to all field offices addressing issues of inconsistency and performance. We suggest that this recommendation read, "The OAM should require that each Hub review its refinanced Section 202/223(f) projects for debt service savings amounts, utilizing data provided from this audit for possible additional debt service savings opportunities resulting in funds put to better use currently estimated at $ 21,097,966 per the audit. Where legally possible, each Hub should identify, account for by project and use these amounts for current and future opportunities benefiting the project tenants or fund housing assistance payments."

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

Cc: Benjamin T, Metcalf, Deputy Assistant Secretary for Multifamily Housing Programs
Nancie-Ann Bodell, Associate Deputy Assistant Secretary for Multifamily Housing Programs
Wayne A. Willard, Director, Buffalo Multifamily Program Center
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Barbara Chiapella, Director, Detroit Multifamily Hub

OIG Evaluation of Auditee Comments

Comment 1 The objectives cited when we began our review were our survey objectives, which are normally broad; however, after the survey we normally refine the objectives. Thus, our audit objective was to determine whether HUD had adequate controls to ensure that Section 202 refinancing was conducted in an effective and efficient manner. For our audit objective we found that HUD did not have adequate controls to ensure that all Section 202 refinancings resulted in economical and efficient outcomes. These deficiencies were due to HUD's lack of adequate oversight and inconsistent nationwide policy implementation regarding debt service savings realized from Section 202 refinancing activities.

Comment 2 HUD indicated that as a result of another programmatic effort over $159 million and $37 million of residual receipts had been used to fund the cost of Housing Assistance Payments in fiscal years 2013 and 2014 respectively to date. HUD indicated that Housing Notice 2012-14 made this possible. We agree that HUD has taken action to apply excess residual balances, which also include debt service saving to fund Housing Assistance Payments and this is mentioned in the report (review of the Pittsburgh Office Refinances). However, HUD has not ensured that this policy, as it relates to debt service savings, was properly implemented in all field offices; as each field office reviewed handled debt service savings differently.

Comment 3 Public Law 106-569 provides that upon execution of the refinancing of a project, the HUD Secretary shall make available at least 50 percent of the annual savings resulting from reduced Section 8 or other rental housing assistance contracts in a manner that is advantageous to the tenants, including reducing the rents of the unassisted tenants in a prorata sharing of the savings from the refinancing. Therefore, the public law implied that annual savings in debt service costs from the refinancing would result in lower costs for Section 8 and housing assistance, which should be used to benefit tenants. Despite the public law's allowance for debt service savings to reduce or offset housing assistance and thus save millions of dollars in housing subsidies, there was no mechanism to ensure that this was done. The total debt service savings over the years for projects refinanced before 2012 are calculated to be at least $183.3 million, and a significant amount of these funds (50% or $91.75 million) could have been available to reduce housing assistance payments or offset rent increases. This amount which was available for reducing or offsetting housing assistance payment are in addition to the annual debt service savings we conservatively reported in the funds to be put to better use section of the report.

Comment 4 The next to last paragraph on page 7 that refers to projects that the Buffalo, New York HUD Office processed under Public Law 111-372, the "new policy" is reflected correctly. HUD's Public Housing staff calculated the annual debt service savings for the 19 projects financed under the new policy to be $625,293. Thus, all debt service savings should be used in calculating the annual housing assistance payment budget, as this is a national issue for which HUD should consider having all field offices use to offset housing assistance payments.

Comment 5 We did not say eliminate the debt service savings escrow accounts, however, we encourage HUD to work with project owners to review the debt service savings in the escrow accounts and help determine what action can be taken to use these funds to benefit tenants and reduce housing assistance payments, as part of the audit resolution process.

Comment 6 We did not say that debt service savings should be used as they are being accrued. What we are saying is that although the debt service savings were required to be deposited in the residual receipts account, these funds were not tracked and there is no record of how the debt service savings were used. Some projects had accumulated very large residual receipts balances, which could indicate that most of the debt service saving had not be used to reduce housing assistance payments or to benefit tenants.

Comment 7 It is possible that debt service savings may have resulted in lower rent increases but this cannot be substantiated as there was a lack of accountability as to how the funds were used. Furthermore, we noted that one project received a total of 7.4 percent in rent increases while having almost $100,000 of additional funding from the debt service savings, which resulted in additional Housing Assistance Payments.

Comment 8 Twelve projects in the Detroit Office were approved for refinancing although they resulted in negative debt service savings. HUD indicated that about half of these projects had rent savings and that there were mitigating considerations for the others. Public Law 106-569 Section 811 (a)(2) provided that the Secretary shall approve the prepayment of any indebtedness if the refinancing results in a lower interest rate on the principal of the loan and reductions in the debt service on the loan. Thus, there was no provision for approving projects for refinancing if they did not meet these requirements.

Comment 9 We revised recommendation 1A based on HUD's comments but kept the original recommendation 1E, which is now 1C, because HUD needs to comply with the requirement to generate positive debt service savings or the limited exception to this requirement related to 6 percent or lower interest rates, as this issue was not addressed in HUD's proposed recommendations

Comment 10 We combined the original recommendations 1B, 1C and 1D into the current recommendation 1B as suggested by HUD but kept the funds to be put to better use in the current revised recommendation 1A. The funds to be put to better use are an annual recurring amount of debt service savings if HUD implements our recommendation; it will ensure that the annual debt service savings of more than $21 million will be properly safeguarded and used as intended for allowable purposes to benefit the projects, tenants, or both and reduce or offset future housing assistance payments.

Appendix C

CRITERIA

The public law related to the refinancing of multifamily Section 202 projects into FHA insurance under section 223(f) is as follows. Public Law 106-569, specifically, Title VIII, Housing for Elderly and Disabled Families, published on December 27, 2000, contained Subtitle A, Refinancing for Section 202 Supportive Housing for the Elderly. Included in the law was the statement "…the [HUD] Secretary shall approve the prepayment of any indebtedness to the Secretary relating to any principal and interest under the loan as part of a prepayment under which (1) the project sponsor agrees to operate the project until the maturity date of the original loan under terms at least as advantageous to existing and future tenants…, and (2) the prepayment may involve refinancing of the loan if such refinancing results in a lower interest rate on the principal of the loan for the project AND in reductions in debt service related to such loan." There were no provisions in the 2000 law for refinancings that resulted in higher debt service or negative debt service savings.

Another provision in the Act, entitled "Use of Unexpended Amounts," stated, "Upon execution of the refinancing for a project pursuant to this section, the Secretary shall make available at least 50 percent of the annual savings resulting from reduced Section 8 or other rental housing assistance contracts in a manner that is advantageous to the tenants, including (1) not more than 15 percent of the cost of increasing the availability or provision of supportive services, which may include the financing of service coordinators and congregate services; (2) rehabilitation, modernization, or retrofitting of structures, common areas, or individual dwelling units; (3) construction of an addition or other facility in the project, including assisted living facilities (or, upon the approval of the Secretary, facilities located in the community where the project sponsor refinances a project under this section, or pools shared resources from more than one such project) or (4) rent reduction of unassisted tenants residing in the project according to a pro rata allocation of shared savings resulting from the refinancing."

The law did not prohibit HUD from using at least 50 percent of the debt savings for housing assistance payment offsets and implied that the refinance savings would result in reduced Section 8 or housing assistance payments. In August 2002, HUD issued Notice H 2002-16, which provided guidance on implementing the public law and included language similar to the law as stated above. The notice provided, in part, as follows:

Use of project-based Section 8 contract savings

A. Upon approval of the refinancing of a project under this Notice and recordation of the Section 202 Use Agreement, the Secretary shall make available at least 50 percent of the annual savings resulting from reduced Section 8 or other rental housing assistance contracts in a manner that is advantageous to the tenants-specifying the 4 items listed above.

HUD did not provide for what to do with the remaining savings (the other 50 percent) from refinancings or in what manner or how long to make 50 percent of the housing assistance savings available to the projects. In addition, while the notice referred to the savings as "Section 8 Contract savings," our fieldwork showed that it is commonly referred to as "debt service savings."

Public Law 111-372 resulted in changes to the above requirements for refinancing Section 202 loans and was implemented by Notice H 2012-8 on May 4, 2012. The major changes in the new policy included eliminating the requirement to escrow debt service savings and the requirement that at least 50 percent of the annual savings be used for specific purposes benefiting the tenants.

Notice H 2012-8, dated May 4, 2012, requires projects to quantify annual debt savings, but there is no provision for the use of the savings. The new notice applies only to projects that had not been approved for refinancing by HUD as of May 4, 2012. In addition, both the public law and the notice allow the refinancing of Section 202 projects without reductions in debt service (negative debt savings) but only for refinancings approved after May 4, 2012, and meeting certain other provisions, which are specified in the notice.