



Office of Community Planning and Development, Washington, DC

Section 108 Loan Guarantees Program

**Office of Audit, Region 4
Atlanta, GA**

**Audit Report Number: 2017-AT-0001
April 27, 2017**





To: Stanley Gimont, Acting Deputy Assistant Secretary for Grant Programs, DG

//signed//

From: Nikita N. Irons, Regional Inspector General for Audit, 4AGA

Subject: HUD's Oversight of Section 108 Loans Was Not Adequate To Ensure Compliance With Program Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's oversight of Section 108 loans.

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

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

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



Audit Report Number: 2017-AT-0001

Date: April 27, 2017

HUD's Oversight of Section 108 Loans Was Not Adequate To Ensure Compliance With Program Requirements

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development (HUD), Office of Community Planning and Development's (CPD) Section 108 Loan Guarantees program. We conducted the audit as part of our annual audit plan. Our audit objectives were to determine whether HUD had adequate oversight of Section 108 loans to ensure that funds were effectively used to meet a Community Development Block Grant national objective and fully provided the intended benefits and that borrowers complied with loan contract provisions.

What We Found

HUD's oversight of Section 108 loans was not adequate to ensure that funds were effectively used to meet program objectives and that borrowers complied with loan contract provisions. The Section 108 loans were not routinely included in HUD's annual reviews. Specifically, of 14 loans reviewed, 12 totaling more than \$102 million had not been monitored. As a result, HUD had no assurance that more than \$24 million in Section 108 loans fully provided the intended benefits and met program objectives and that borrowers complied with program requirements.

What We Recommend

We recommend that CPD (1) determine the eligibility of more than \$15.8 million in unsupported Section 108 fund disbursements for activities that did not meet a national objective, (2) require borrowers to use more than \$8.6 million in unused commitments to meet program objectives, (3) determine the eligibility of \$75,000 disbursed for an activity without HUD approval, and (4) improve its monitoring policies, procedures, and tracking systems to ensure that borrowers comply with all loan contract provisions and that required documents are submitted.

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Background and Objectives

The Section 108 Loan Guarantees program is the loan guarantee provision of the Community Development Block Grant program. Section 108 loans provide grantees with a source of financing for economic development, housing rehabilitation, public facilities, and large-scale physical development projects. The principal security for the loan guarantees is a pledge by the grantee or the State of current and future Block Grant funds. Section 108 obligations are financed through underwritten public offerings and may be for terms of up to 20 years. An entitlement public entity may apply for up to five times the latest approved Block Grant amount.

HUD's Financial Management Division, within the office of Community Planning and Development (CPD), administers the program. Both HUD headquarters and field offices play a role in managing the loan program. Generally, headquarters provides final approval, negotiates loan terms with applicants, and arranges for the sale of the loans. Field offices assist communities and States in preparing applications, make recommendations to headquarters to approve or deny loans, and monitor funded activities.

The Block Grant rules and requirements apply in determining project and activity eligibility. All projects and activities must meet one of the following three national objectives of the Block Grant program: (1) principally benefit low- and moderate-income persons, (2) assist in eliminating or preventing slums and blight, or (3) assist with community development needs having a particular urgency. In addition, Section 108-funded activities are exposed to the same HUD monitoring requirements as other Block Grant activities.

Between January 1, 2008, and December 31, 2015, HUD approved more than \$1.4 billion in Section 108 loans.

Year	Amount	Number of loans approved
2008	\$134,759,000	25
2009	229,831,000	28
2010	232,724,000	38
2011	180,710,000	26
2012	199,534,000	29
2013	224,350,000	14
2014	123,637,000	18
2015	108,271,000	19

Our audit objectives were to determine whether HUD had adequate oversight of Section 108 loans to ensure that funds were effectively used to meet a Block Grant national objective and fully provide the intended benefits and that borrowers¹ complied with loan contract provisions.

¹ For purposes of this report, the term "borrower" means a grantee or any designated public agency carrying out a Section 108-funded activity.

Results of Audit

Finding: HUD's Oversight of Section 108 Loans Was Not Adequate To Ensure Compliance With Program Requirements

HUD's oversight of Section 108 loans was not adequate to ensure that funds were effectively used to meet program objectives and that borrowers complied with loan contract provisions. The Section 108 loans were not routinely included in HUD's annual reviews.² Specifically, of 14 loans reviewed, 12 totaling more than \$102 million had not been monitored. For the 12 loans for which adequate oversight was not provided, 2 loans had not fully met a national objective of the Block Grant program, 2 loans had unused loan commitments, and the borrower of 1 loan used loan funds for an activity that HUD had not approved. Additionally, for the 14 loans reviewed, required bank agreements, monthly statements, or security documents were missing, similar to deficiencies identified in prior Office of Inspector General (OIG) audit reports. These conditions occurred because HUD's monitoring procedures were not specific regarding whether Section 108 loans should be included in the annual reviews of Block Grant recipients. In addition, HUD did not take adequate enforcement action against borrowers that did not meet loan contract provisions. As a result, HUD had no assurance that more than \$24 million in Section 108 loans fully provided the intended benefits and met program objectives and that borrowers complied with program requirements.

Infrequent Monitoring Reviews

HUD headquarters officials informed us that field offices were responsible for conducting monitoring reviews of Section 108 loans based on a risk assessment and that the reviews were the primary means for ensuring that borrowers complied with program requirements. HUD field offices conducted biennial risk assessments of Block Grant grantees to determine which grantees would be monitored. The risk assessment was based on a 100-point rating scale, on which grantees were assigned one of three risk categories: high risk - a total score of 51 or more, medium risk - a score between 30 and 50, and low risk - a score of less than 30. It assigned one point to grantees that had a Section 108 loan and three points if the loan was combined with Economic Development Initiative or Brownfields Economic Development Initiative grants.³ The Director of CPD's Office of Field Management informed us that even if a grantee was selected for monitoring based on the risk assessment score, there was no requirement to include Section 108 loans as part of the annual review. Therefore, routine onsite monitoring of Section 108 projects would not occur.

²An annual review might consist of the field office's conducting (1) an onsite review during which a team reviewed various aspects of activities to determine compliance with Block Grant program requirements or (2) an in-house assessment during which HUD identified areas in which recipients were doing well and those in which they needed improvement.

³The risk assessment was not designed to flag Section 108 projects for monitoring. It was used as a tool to obtain a total score and determine which grantees would be monitored.

HUD records showed that monitoring reviews were not frequent or routine. HUD had not conducted monitoring reviews for 12 of 14 (85 percent, \$102.5 million) loans reviewed. Between 327 and 2,533 days had elapsed since the loan contract date, and monitoring reviews had not been conducted for the 12 loans. For two loans, HUD’s monitoring review was conducted between 682 and 901 days after the contract date.

Loan number	Amount	Loan contract date	Monitoring performed	Days elapsed without a HUD monitoring review since contract date*
B-08-MC-06-0523-B	\$25,000,000	Nov. 19, 2009	No	2,533
B-08-MC-06-0041	1,320,000	July 21, 2010	No	2,289
B-10-MC-17-0006	15,000,000	Jan. 07, 2011	No	2,119
B-10-DC-42-0001	15,000,000	Jan. 25, 2011	No	2,101
B-09-MC-06-0518	2,000,000	Oct. 20, 2011	No	1,833
B-09-UC-36-0103	500,000	Nov. 17, 2011	No	1,805
B-08-MC-47-0006	9,914,000	Nov. 17, 2011	No	1,805
B-11-MC-26-0025	5,900,000	Oct. 19, 2012	No	1,468
B-10-UC-12-0004	2,558,000	Mar. 06, 2013	No	1,330
B-10-UC-36-0103-A	615,000	Apr. 05, 2013	No	1,300
B-12-MC-36-0003	20,000,000	Feb. 27, 2014	No	972
B-14-MC-55-0002	4,700,000	Dec. 04, 2015	No	327
B-10-MC-21-0002	1,500,000	Nov. 17, 2011	Yes ⁴	901
B-11-MC-06-0523	12,500,000	Nov. 16, 2012	Yes ⁵	682
Total	116,507,000			

* As of October 26, 2016

The infrequent monitoring of Section 108 loans was not consistent with section 104(e)(1) of the Housing and Community Development Act of 1974. HUD must conduct performance reviews at least annually to determine whether the grantees have carried out Block Grant activities in a timely manner, in accordance with the program requirements, and in compliance with primary and national objectives.

A 1997 report from the U.S. Government Accountability Office disclosed similar deficiencies regarding HUD’s oversight of the Section 108 Loan Guarantee program. According to the report, some HUD field offices did not routinely include the Section 108 loans in their annual reviews because they (1) did not believe they had guidance on how to monitor the program, (2) did not believe they had a responsibility to monitor the loans, (3) had other priorities, or (4) lacked loan-specific information. The report recommended that HUD direct field offices to include a review of Section 108 activities when they reviewed Block Grant communities and States and develop procedures to ensure that the information necessary to monitor the program

⁴HUD monitoring conducted on May 6, 2014

⁵HUD monitoring conducted on September 29, 2014

was promptly provided to field offices. HUD agreed with the recommendations and stated that it would take appropriate corrective measures. However, the deficiencies continued to exist.

Program Requirements Not Met

HUD's oversight of Section 108 loans was not adequate to ensure that funds were effectively used to meet program objectives and that borrowers complied with loan contract provisions. For the 12 loans for which adequate oversight was not provided, 2 loans had not fully met a national objective of the Block Grant program, 2 loans had unused loan commitments, and the borrower of 1 loan used Section 108 funds for an activity that HUD had not approved. In addition, for the 14 loans reviewed, borrowers did not follow loan contract provisions. Required bank agreements, monthly statements, or security documents were missing.

National objective not fully met - Two Section 108 loans totaling more than \$15.8 million had not fully met a national objective of the Block Grant program.

- Loan number B-08-MC-47-0006 - On August 23, 2010, HUD approved the use of more than \$9.9 million for the conversion of a basketball stadium into a retail center.⁶ The national objective for this project was to benefit low- and moderate-income persons through job creation. A total of 288 full-time jobs were to be held by or made available to low- and moderate-income persons. According to information the Knoxville HUD field office provided us, the activity had not fully met a national objective because only 244 jobs were made available, and 152 positions had been filled by low- and moderate-income persons.
- Loan number B-11-MC-26-0025 - On September, 13, 2012, HUD approved the use of \$5.9 million for the renovation of a historic building into a mixed-use project consisting of retail, office space, and apartment units. The national objective for this project was to benefit low- and moderate-income persons through job creation. A total of 117 full-time jobs were to be held by or made available to low- and moderate-income persons. According to information the Detroit HUD field office provided us, the activity had not fully met a national objective because only 42 jobs had been made available and filled by low- and moderate-income persons.

Unused loan commitments - Two Section 108 loans totaling more than \$11.8 million had signs of slow progress because borrowers had drawn only a portion of the total loan amount HUD approved. As a result, more than \$8.6 million in loan commitments had not been used in a timely manner to meet program objectives and provide the intended benefits.

- Loan number B-10-UC-36-0103-A - On January 23, 2012, HUD approved the use of more than \$1.8 million for the establishment of two economic development loan funds. According to the loan contract, all proceeds had to be withdrawn and disbursed by December 31, 2014. However, the borrower had drawn and used \$615,000, leaving more

⁶The project was also awarded an additional \$2 million in Brownfields Economic Development Initiative funds.

than \$1.2 million in unused loan commitments. The last advance of Section 108 loan proceeds to the borrower took place in August 2013. As a result, more than 3 years had elapsed since the borrower received funding, and it had not used the full approved loan amount to provide economic development loans.

- Loan number B-10-UC-12-0004 - On September 19, 2011, HUD approved the use of \$10 million to provide loan assistance to new and existing businesses in distressed areas. According to the loan agreement, all loan proceeds had to be withdrawn and disbursed by October 31, 2015. However, the borrower had drawn and used \$2.55 million, leaving more than \$7.44 million in unused loan commitments. The last advance of Section 108 loan proceeds to the borrower took place in September 2013. As a result, more than 3 years had elapsed since the borrower received funding, and it had not used the full approved loan amount to provide loan assistance to businesses in distressed areas.

Funded activity without HUD approval - On January 23, 2012, HUD approved the use of more than \$1.8 million for the establishment of two economic development loan funds (B-10-UC-36-0103-A). Paragraph 15(b) of the loan contract provided that the borrower should not incur obligations to be paid with guaranteed funds before receiving a written eligibility determination from the HUD field office. On November 1, 2013, the borrower disbursed \$75,000 in Section 108 funds for an activity that did not have HUD approval.

Contract provisions not followed - HUD did not properly ensure that borrowers followed provisions of the Section 108 loan contract. For 14 loan files reviewed, required bank agreements, monthly statements, or security documents were missing.

- Bank agreements - The loan contract required borrowers to establish custodial bank accounts governed by letter agreements that provided HUD with the authority to take control over the account in case the borrower defaulted. Borrowers were required to forward copies of the executed agreements to HUD. However, 10 of the 14 files did not contain such agreements. As a result, HUD had no assurance that funds were deposited into the required accounts, and HUD's interest could be at risk if a borrower defaulted.
- Monthly statements - The loan contract established monthly reporting requirements that permitted HUD to track and verify the use of Section 108 funds as well as the use of any program income generated. Each month, borrowers should provide HUD with a written statement showing the deposits, withdrawals, and balances of their bank accounts for Section 108 loan funds, as well as a statement identifying the obligations and their assignments in their investment accounts for loan funds. For 10 of 14 loans reviewed, the borrower did not submit the required monthly statements. For the four loans for which borrowers submitted the statements, we found one instance in which information was not consistent with HUD's requirement. For example, the statement consisted of a list of individual loans the borrower made to businesses with no information on when the disbursements occurred and whether any program income was generated and its disposition.

In January 2017, the headquarters program office provided additional monthly statements that it obtained after we informed it of the deficiencies noted above. We examined the additional documents and found that the information some borrowers provided was incomplete, funds were not spent in a timely manner, and Section 108 loan proceeds were comingled with other funds.

- The statement format varied among borrowers and did not contain sufficient information on the use of funds. For example, one of the monthly statements consisted of a copy of a wire transfer request that was dated before the borrower had received the Section 108 funds. Another borrower submitted a copy of a general ledger, but the information included did not properly show the use of Section 108 funds. Other borrowers submitted copies of the bank statements of the Section 108 accounts without a proper description of the transactions. These documents did not contain sufficient information to determine whether the borrower complied with HUD’s requirements.
- The bank statements of five borrowers showed that they did not disburse Section 108 funds in a timely manner. The statements showed that the Section 108 accounts had unspent funds, although the expenditure deadline had expired.

Loan number	Disbursement deadline	Statement period	Account balance
B-08-MC-06-0523-B	Nov. 15, 2011	July 2016	\$8,102,693 ⁷
B-14-MC-55-0002	Aug. 31, 2016	Dec. 2016	1,115,093
B-09-UC-36-0103	Sept. 30, 2013	July 2016	382,370 ⁷
B-10-MC-21-0002	Aug. 31, 2016	Sept. 2016	329,793
B-12-MC-36-0003	Sept. 30, 2015	Oct. 2016	30,027

- The bank statements of three borrowers showed that Section 108 loan proceeds were comingled with other funds. The borrower did not establish an individual account for the Section 108 funds as required by the loan contract.

HUD had no assurance of whether borrowers disbursed Section 108 funds within the established deadlines and in accordance with program requirements. A field office official informed us that monthly reports were sent directly to headquarters by the borrowers but the reports were not forwarded to the field office. As a result, the field office lacked adequate information to identify potential risks and assess whether borrowers disbursed all Section 108 funds in accordance with program requirements.

- Security documents - The loan contract established additional security requirements with which the borrower had to comply to further secure HUD’s interests. Examples of the additional security included liens, mortgage deeds, pledges, and other legal instruments

⁷Section 108 loan proceeds were deposited into a bank account and comingled with other funds.

granting rights to the HUD Secretary in case a borrower defaulted. The Section 108 loan contract typically required borrowers to execute an agreement with a document custodian to safeguard the documents pertaining to the additional security. Borrowers were required to submit to HUD a copy of the custodian agreement when the additional security documents were delivered to the custodian. For 12 of 14 loans reviewed, the custodian agreement was not in the loan file. As a result, HUD had no assurance that borrowers complied with the additional security requirements, and HUD could be at risk in the event of a loan default.

The table below summarizes the deficiencies of the 14 loans reviewed.

Loan number	Approval date	Amount	Missing bank agreements	Missing monthly statements	Missing security documents
B-08-MC-06-0523-B	Sept. 25, 2008	\$25,000,000		X	X
B-08-MC-06-0041	Sept. 25, 2009	1,320,000	X	X	X
B-08-MC-47-0006	Aug. 23, 2010	9,914,000			X
B-09-UC-36-0103	Dec. 14, 2010	500,000	X	X	X
B-10-DC-42-0001	Dec. 17, 2010	15,000,000	X	X	X ⁸
B-10-MC-17-0006	Dec. 20, 2010	15,000,000	X	X	X
B-09-MC-06-0518	Dec. 23, 2010	2,000,000	X	X	X
B-10-MC-21-0002	Mar. 29, 2011	1,500,000			X
B-10-UC-12-0004	Sept. 19, 2011	2,558,000	X		X
B-10-UC-36-0103-A	Jan. 23, 2012	615,000	X	X	X
B-11-MC-06-0523	May 3, 2012	12,500,000	X	X	X
B-11-MC-26-0025	Sept. 13, 2012	5,900,000	X	X	
B-12-MC-36-0003	Sept. 27, 2012	20,000,000	X	X	
B-14-MC-55-0002	Mar. 11, 2015	4,700,000			X
Total		116,507,000	10	10	12

The HUD headquarters program office established spreadsheets to track borrowers' compliance with the submission of monthly statements, security documents, and bank agreements. However, these spreadsheets were incomplete and inaccurate. For example, the spreadsheet to track monthly statements included information on the borrowers that submitted statements but excluded those that had not submitted statements. The spreadsheet used to track security documents was also inaccurate. For example, the spreadsheet stated that a borrower was not required to submit a custodial agreement, although the loan contract required the agreement submission. In another example, the corresponding section of the spreadsheet was left blank. As a result, HUD did not have an accurate and proper means of tracking and assessing compliance with the submission requirements of the loan contract.

HUD headquarters officials informed us that borrowers were instructed to submit the required

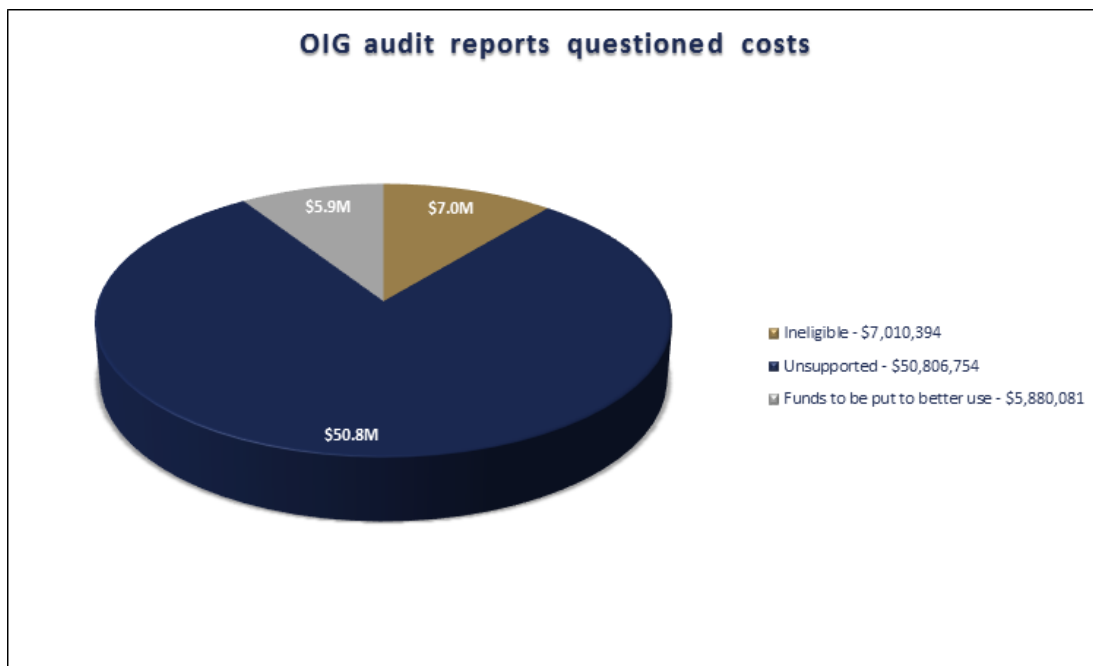
⁸The loan contract designated the borrower as custodian of the security documents and required the submission of a legal opinion to HUD on the authority of the subrecipient and the validity of the subrecipient agreement. The legal opinion was not in the loan file.

documents but not all borrowers complied. Although Section 108 borrowers did not always follow program reporting requirements, HUD had not always enforced the reporting requirements or taken action against borrowers. The Director of the CPD Financial Management Division informed us that beginning in fiscal year 2017, field offices would start obtaining the required documents, declare borrowers in default, and implement remedial actions for borrowers that did not comply.

For 14 loans totaling \$116.5 million, HUD files did not contain required loan documentation. Although HUD had established a framework to track borrowers' compliance with reporting and submission requirements, the framework consisted of fragmented spreadsheets that were not current and contained inaccurate information. As a result, HUD had no assurance that borrowers complied with program requirements, and it could be at risk if a borrower defaults on a loan.

Prior OIG Reports

HUD OIG issued 10 (9 external and 1 internal) reports pertaining to the Section 108 loan program between 2008 and 2016 with a total of 64 recommendations.⁹ These reports identified more than \$57 million in questioned costs and more than \$5 million in funds to be put to better use. See the figure below for details of the questioned costs. According to HUD's records, only one of the Section 108 loans had been monitored at the time of the OIG audits.



We reviewed the 10 reports to identify recurring deficiencies. The most common problem areas were related to national objective, custodial bank account, loan collateral, and loan proceeds expenditures. Appendix D shows a complete listing of the most common deficiencies found.

⁹Appendix C shows a complete listing of the OIG reports pertaining to the Section 108 program.

National Objective

The most commonly recurring deficiency was Section 108-funded activities not meeting a national objective of the Block Grant program. Seven OIG reports contained findings related to funded activities that had signs of slow progress, did not provide the intended benefits, and failed to meet a national objective, resulting in more than \$41 million in questioned costs.

For example, the Office of the Commissioner for Municipal Affairs, San Juan, PR, sponsored the use of more than \$31 million for four activities that reflected slow progress without assurance that the activities would provide the intended benefits.¹⁰ In another example, the City of Newburgh, NY, invested more than \$1.6 million for the development of an industrial park without assurance that the activity was feasible for commercial development and job creation.¹¹ The pictures below show the condition of the project sites when we performed a site inspection.



Picture 1 - Audit memorandum 2014-AT-1801, Vieques, PR, a sport complex site was abandoned, and the main recreational building and the baseball facilities were covered with dense vegetation.

¹⁰2014-AT-1801 and 2015-AT-1001, Office of the Commissioner for Municipal Affairs, San Juan, PR

¹¹2009-NY-1001, City of Newburgh, NY



Picture 2 - Audit report 2015-AT-1001, Dorado, PR, a hotel project site was not developed. More than 7 years had elapsed since Section 108 funds were approved for the activity, and the intended benefits had not been achieved.



Picture 3 - Audit report 2015-AT-1001, Camuy, PR, a hotel project site had not been developed. More than 8 years had elapsed since HUD approved the Section 108 funds for the activity, and the intended benefits had not been achieved.



Picture 4 - Audit report 2015-AT-1001, San Lorenzo, PR, an activity center site had not been developed and converted to a parking facility. More than 8 years had elapsed since HUD approved the Section 108 funds for the activity, and the intended benefits had not been achieved.



Picture 5 - Audit report 2009-NY-1001, the City of Newburgh, NY, an industrial park site had not been developed. More than 17 years had elapsed since HUD approved the Section 108 funds for the activity, and the intended benefits had not been achieved.

Custodial Bank Account

The second most common deficiency noted in OIG audit reports related to borrowers' failure to maintain program bank accounts in accordance with the loan contract. Six OIG reports identified instances in which borrowers did not establish loan repayment accounts, funds were maintained in bank accounts without assurance that they were fully collateralized with government obligations, and program income was not deposited into a custodial account to guarantee the repayment of the loan.

For example, the City of Binghamton, NY, failed to establish a loan repayment account.¹² In another example, the Municipality of Toa Alta, PR, maintained deposits of more than \$1.4 million in Section 108 loan proceeds at a commercial bank without ensuring that these funds were fully collateralized with government obligations.¹³

Loan Collateral

The third most commonly occurring deficiency noted in OIG reports related to borrowers' failure to comply with collateral requirements to further secure HUD's interests. Five OIG reports identified instances in which borrowers did not provide HUD with appropriate liens, mortgage deeds, pledges, and other legal instruments granting rights to HUD in case a borrower defaulted.

For example, the Office of the Commissioner for Municipal Affairs, PR, did not ensure that the borrower provided additional security to assure the repayment of the debt. As a condition for receiving the assistance, the borrower was required to submit additional security in the form of a sole first priority lien of real property within an established timeframe. For one loan, the lien was filed more than 3 years after the deadline. For another three loans, the lien was overdue and had not been filed by the borrower.¹⁴ In another example, the City of Yonkers, NY, did not inform HUD that it had sold the property that was pledged as collateral for a loan.¹⁵

Loan Proceeds Expenditure

The fourth most common deficiency, found in four reports, involved borrowers' failure to spend loan proceeds before the loan contract deadline, resulting in \$6.7 million in questioned costs and more than \$752,000 in funds to be put to better use. For example, the City of Newburgh, NY, maintained unused Section 108 loan proceeds totaling \$652,800 in the project bank account for more than 7 years.¹⁶ In another example, the City of Rochester, NY, did not draw down and disburse the \$6.7 million in Section 108 funds before the loan contract deadline.¹⁷

Monitoring Procedures Deficient

HUD did not have clear procedures advising field offices on whether reviews of Section 108 activities were mandatory or when the activities should be monitored. The HUD headquarters program director informed us that he believed that when the field office selected a Block Grant

¹²2011-NY-1004, The City of Binghamton, NY

¹³2016-AT-1002, The Municipality of Toa Alta, PR

¹⁴2015-AT-1001, Office of the Commissioner for Municipal Affairs, San Juan, PR

¹⁵2009-NY-1009, The City of Yonkers, NY

¹⁶2009-NY-1001, The City of Newburgh, NY

¹⁷2016-NY-1003, City of Rochester, NY

grantee for the annual review, the Section 108-funded activities should be included in the review. However, the Director of the CPD Office of Field Management informed us that even if a grantee was selected for review (based on the risk assessment score), there was no requirement for the field office to include Section 108 activities as part of the monitoring review. HUD field office officials informed us that reviews of Section 108 loans were not mandatory and that they lacked complete loan information because the loans were managed at the HUD headquarters program office. As a result, the HUD headquarters program office and field offices had opposing positions on whether to routinely include the Section 108 loans in the annual reviews of grantees. In addition, field offices lacked necessary information to properly assess risk and monitor the Section 108 loans.

HUD lacked a proper system for identifying and tracking the loans that had been subject to monitoring reviews. HUD uses the Grant Management Process¹⁸ and the Integrated Disbursement and Information System¹⁹ for monitoring. However, these systems did not provide sufficient information to readily identify the Section 108 loans that were subject to HUD's annual reviews. As a result, HUD did not have assurance that Section 108 loans were properly reviewed in accordance with regulations. HUD officials informed us that modifications to HUD's systems to assist in monitoring Section 108 loans began in October 2013 but these efforts were suspended because of a lack of funds.

Conclusion

HUD's oversight of the Section 108 activities had been infrequent because it did not have adequate procedures. The lack of adequate and timely monitoring of funded activities could jeopardize the success of the program. In addition, HUD had no assurance that Section 108 funds were effectively used to meet program objectives and that borrowers complied with loan contract provisions.

Recommendations

We recommend that the Office of Community Planning and Development

- 1A. Reevaluate the feasibility of the two Section 108 activities that failed to meet a national objective and determine the eligibility of the \$15,814,000 already invested. Any amount determined ineligible must be reimbursed to the program from non-Federal funds.
- 1B. Require the borrowers to submit a plan for how they will proceed and use the \$8,694,000 million in unused commitments to provide the intended benefits and meet program objectives.

¹⁸ HUD's Grants Management Process system is an information system that complements HUD's management function in monitoring grantee compliance with statutes and regulations.

¹⁹ HUD's Integrated Disbursement and Information System is the drawdown and reporting system for the Block Grant program and includes information regarding activities across the Nation, including funding and accomplishment data. HUD uses this information to report to Congress and to monitor grantees.

- 1C. Require the borrower to provide all supporting documentation and evaluate the allowability and eligibility of \$75,000 used for the unauthorized activity. Any amount determined ineligible must be reimbursed to the program from non-Federal funds.
- 1D. Develop procedures directing field offices to include the review of Section 108-funded activities when performing the annual reviews of Block Grant recipients.
- 1E. Develop procedures to ensure that the information necessary to monitor program performance and compliance with program requirements is promptly provided to the field offices.
- 1F. Implement procedures to ensure that borrowers comply with all loan contract provisions and that required documents are submitted, including bank agreements, monthly statements, and security documents. If a borrower does not provide evidence that it has complied with all program requirements, HUD must initiate appropriate remedial actions under paragraph 12 of the contract.
- 1G. Develop and implement a tracking system for monitoring reviews of Section 108 loans.

Scope and Methodology

We conducted the audit from April 5, 2016, through January 27, 2017, at HUD's offices located in Washington, DC, and our offices located in San Juan, PR. The audit generally covered the period January 1, 2008, through December 31, 2015.

To accomplish our objectives, we reviewed

- Applicable laws, regulations, handbooks, and Section 108 loan files and contracts and
- HUD monitoring reports and data contained in HUD's systems.

We interviewed HUD officials located in Washington, DC, and in the field offices responsible for the loans selected for review. We also performed site inspections of construction and rehabilitation activities.

To achieve our audit objectives, we relied in part on computer-processed data from HUD's Excel spreadsheets to determine the Section 108 loan population and select a sample of loans for review. We also relied on computer-process data from HUD's Integrated Disbursement and Information System and Grant Management Process to identify the progress and monitoring status of the loans reviewed. 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 adequate for our purposes.

HUD records showed that between January 1, 2008, and December 31, 2015, it authorized the issuance of more than \$810 million in promissory notes associated with 144 Section 108 loans. Of these loans, we statistically selected a sample of 60 loans totaling more than \$343 million. We used statistical sampling because each sampling unit was selected without bias from the audit population and selecting 100 percent of the approved loans for testing was not feasible. We did not review all 60 loans in our sample but limited our review to 14 loans in the sample list, which totaled more than \$116 million. The results of the audit apply only to items selected for review and cannot be projected to the universe or population. The 14 loans were reviewed to determine whether HUD had monitored the loan to ensure that funds were effectively used to meet a national objective, and that borrowers complied with loan contract provisions.²⁰

We identified and reviewed 10 HUD OIG audit reports (2008-2016) with findings and conclusions related to Section 108. We summarized the information from these reports to identify common findings for inclusion in our report.

²⁰Loan B-12-MC-36-0003 was previously reviewed by OIG; audit report 2016-NY-1003 (February 5, 2016).

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

Internal Controls

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

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

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

Relevant Internal Controls

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

- Program operations - Policies and procedures that management has implemented to provide reasonable assurance that a program meets its objectives, while considering cost effectiveness and efficiency.
- Compliance with laws and regulations - Policies and procedures that management has implemented to reasonably ensure that program implementation is consistent with laws and regulations.
- Safeguarding of assets - Policies and procedures that management has implemented to reasonably prevent and promptly detect unauthorized acquisition, use, or disposition of assets and resources.

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:

- HUD's oversight of Section 108 activities was not adequate to ensure compliance with program requirements (finding).

Appendixes

Appendix A

Schedule of Questioned Costs and Funds To Be Put to Better Use

Recommendation number	Unsupported 1/	Funds to be put to better use 2/
1A	\$15,814,000	
1B		\$8,694,000
1C	75,000	
Totals	15,889,000	8,694,000


- 1/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.
- 2/ 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 HUD implements our recommendations, it will ensure the timely use of unspent commitments and help meet and maximize program objectives.

Appendix B

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-7000

OFFICE OF COMMUNITY PLANNING AND DEVELOPMENT

MAR 27 2017

TO: Nikita N. Irons, Regional Inspector General for Audit, 4AGA



FROM: Stanley Gimont, Deputy Assistant Secretary for Grant Programs (Acting), DG

SUBJECT: Discussion Draft Audit Report – Section 108 Loan Guarantee Program

Thank you for the feedback provided as a result of this audit. It will be used to strengthen CPD oversight of the Section 108 program. CPD also appreciates the professionalism and cooperation of German Perez and his team in their conduct of the audit.

CPD has reviewed the draft report and recommendations for addressing the issues raised in that report. Specific comments on the contents of the draft report are provided below, but it is important to emphasize that while CPD shares your goal of ensuring that recipients comply with regulatory and contractual requirements, the Section 108 program has been a valuable tool for communities in addressing their community and economic development needs, providing more than \$6 billion in guaranteed loan financing over the program's history. It has been the catalyst for a dramatic revitalization of entire downtowns, such as Columbus, Georgia's investment in its Uptown neighborhood, and has created more than a hundred thousand jobs in economically distressed communities, including the creation of 42 living wage jobs for worker/owners of a greenhouse facility cooperative business in Cleveland, Ohio.

Section 108 also is distinguished by never having used additional appropriations for payment of default claims. Although projects financed with Section 108 guaranteed financing do not always generate the payback expected (which usually means that pledged grant funds are used to supplement the payback), the fact remains that the repayment of guaranteed loans has never required HUD to use the reserves held in the Section 108 financing account for that purpose.



Images of start-up, cooperative business in Cleveland, Ohio (\$8 million in Section 108) and downtown waterfront redevelopment in Columbus, Georgia (\$14.6 million in Section 108) near Total System Services Inc (TSSYS) campus.

Auditee Comments

Ref to OIG Evaluation

Comment 1

HUD Response to OIG Statement that Infrequent Monitoring Reviews

CPD agrees that improvements in monitoring are needed to ensure that projects are carried out in accordance with program requirements (e.g., national objectives criteria). In that regard, CPD issued REV-7 of the *CPD Monitoring Handbook 6509.2* on February 27, 2017 that included an updated Section 108 monitoring exhibit for use by field offices in conducting on-site monitoring that includes a new section on reporting. Notwithstanding this improvement, sources available to field offices are too limited and Section 108 loan requirements are too complex to rely exclusively on field office monitoring. Consequently, the Section 108 office, CPD's Financial Management Division, will assume greater responsibility in tracking compliance through system and process enhancements and providing field offices with guidance and tools, including reports, to assist with assessing potential compliance issues. In particular, the Section 108 office is pursuing procedural and data system enhancements to ensure loan information is systematically tracked in order to be able to provide field offices with the information necessary for continued oversight of Section 108 recipients' progress in carrying out activities financed with guaranteed loans. For example, the Section 108 office has developed a CPD Notice which is currently in clearance, that provides step-by-step guidance on reporting Section 108 accomplishment activity and financial information in HUD's Integrated Information and Disbursement System (IDIS) for use by Section 108 recipients and field offices. The Section 108 office has also updated its processes to involve field office staff in the loan financing stage so as to ensure field office staff are involved at every step of the process, and, therefore have an improved understanding of contract requirements, including reporting and security documentation requirements.

HUD Response to OIG Statement that Program Requirements Not Met

CPD is also aware that Section 108 borrowers have not always complied with contract requirements (e.g., documentation of additional security). In fact, the Section 108 program staff began a comprehensive review of contract compliance in 2014 to identify borrowers that have not fully complied. When this review revealed missing documentation for any loan, the borrower was notified of the deficiency and given instructions on the steps required to document compliance. For those borrowers that did not respond, or did not respond satisfactorily, the Section 108 office is working on a field office by field office basis to obtain compliance. Reviews of borrowers that are under the jurisdiction of the Caribbean, Boston, Philadelphia, Pittsburgh, Columbus, Atlanta, Oklahoma City, Knoxville, and Hartford field offices are currently underway. Reviews of all field offices are expected to be completed by the end of this fiscal year. The Section 108 office has instituted new procedures to ensure that new loans do not experience similar problems, as fully explained in the next section of this response on the OIG report's recommendations.

While additional detail is included in the next section, greater context is needed with respect to certain of your recommendations. Regarding the draft report's discussion of bank agreements and monthly statements on page 7, it should be understood that every loan does not require all of the bank accounts and agreements referenced in Section 108 contracts and not every borrower is required to submit monthly statements. For example, if a borrower "front-ends" payment of activity costs, which is a fairly common practice among recipients of Section 108 funds, HUD would not require it to establish a "Guaranteed Loan Funds" account and execute the related bank agreement

Comment 3

Auditee Comments

Ref to OIG Evaluation

Comment 3

simply to receive loan proceeds and immediately transfer them to reimburse local accounts. Additionally, if the assisted activity will not generate program income, such as a public improvement activity, the borrower is not required to establish a "Loan Repayment Account" and execute the related bank agreement.

With regard to bank statements, if no bank account is required to be established, or if the funds in the account have been fully disbursed, the borrower is not required to submit a monthly statement. One of the issues CPD is addressing is how to identify those situations when statements are required to be submitted. The integration of Section 108 into IDIS will be of assistance in this regard by enabling HUD to identify the conditions (e.g., receipt in IDIS of program income) that will alert the Section 108 office that monthly reports are required.

As will be discussed further below, new procedures are in place that require borrowers to furnish the Section 108 office with executed bank agreements before a loan is disbursed. Based on the nature of the activity to be undertaken, the Section 108 office will know whether a full complement of bank accounts (and related bank agreements) are required. The Section 108 office also now conducts a preliminary briefing of new recipients to explain the various requirements that apply to the use of the Section 108 financing. This includes discussion of bank account(s) required, reporting requirements and that Section 108 funding must be incorporated in IDIS.

Comment 3

The draft report contains identifying missing documents for the Section 108 projects included in the audit sample. Some of those documents have been submitted and some are not required. In any event, the missing documents will be incorporated in the field office specific reviews mentioned above.

HUD Response to Recurring Issues Noted in Prior OIG Reports

Comment 4

The most frequent recurring issue noted was failure to comply with the CDBG national objectives criteria (which are applicable to activities carried out with Section 108 funds). Some of the draft recommendations are focused on addressing this deficiency and, in general, CPD agrees that additional steps are necessary to ensure that activities meet these criteria. In addition to your recommendations, CPD intends to assign greater responsibility to the Section 108 office for supplementing the on-site monitoring by field offices. Any effort will be subject to budgetary and staffing constraints, but CPD believes that analysis of data available in internal databases and IDIS can identify potential problems so that remedial actions can be taken earlier than has been possible.

Comment 4

The Section 108 office is working with other staff in the Office of Block Grant Assistance and contractors to deploy a process to allow for customized reporting of IDIS data via MicroStrategy reporting suite. It will allow the Section 108 office to create customized data queries and reporting to more effectively monitor performance. This action will enhance CPD's ability to refine existing reports in IDIS and create additional reporting capability for the first time for Section 108. This will be a critical step in enhancing desk review capabilities and mitigate certain program risks (both performance and compliance-based risk metrics).

The draft report states that failure to comply with the requirements for establishing bank accounts and executing related bank agreements are the second most common deficiency. As noted above,

Auditee Comments

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Comment 5

bank accounts are not always required and borrowers are now required at a minimum to furnish executed bank agreements for the Guaranteed Loan Funds account (unless the recipient prefers to front-end payment of activity costs) before loan funds are disbursed. Executed bank agreements for the Loan Repayment Account will also be required if it is clear that program income will be generated by the assisted activities. The table attached (*Attachment 1*) demonstrates that this is the case for several of the loans in the OIG's report. For example, the B-10-UC-36-0103 for Rockland County, New York, would not necessarily be required to establish a Loan Repayment Account since the borrower stipulated it would be repaying the loan from CDBG funding.

Comment 6

Loan collateral issues were the next most common issue. The cited deficiencies concern compliance with secondary and, in some cases, tertiary collateral requirements. Section 108 is designed to be secured primarily by a pledge of current and future grants allocated to a state or unit of general local government under the CDBG program. HUD does not rely on other collateral so long as CDBG funds are available to cover amounts coming due. This is why there has never been payment default on a due date under the guaranteed note as funds on the borrower's CDBG line of credit have been available for payment purposes. With that understanding, CPD agrees that it is essential to remedy past noncompliance with the additional security requirements and to implement procedures to ensure future compliance.

Comment 7

Failure to disburse guaranteed loan funds by the deadline specified in the Section 108 contract was the fourth most common issue. CPD believes the new procedures for monitoring the monthly reporting requirements will address this issue. As described in more detail below, the Section 108 office in the final development stages of a new Microsoft Access database tracking system. This database will replace the current data tracking tools (a legacy database and multiple spreadsheets) with a unified system. The Section 108 office will be expanding data reporting capabilities and allowing for better tracking of milestones, including deadlines for loan fund disbursement. The Section 108 office will have the ability to better track and review compliance with milestones.

HUD Response to Prior Audits

The Section 108 office has reviewed the status of each of the prior audits cited in the draft report. Updates are provided in Attachment 2.

Recommendation 1A. Reevaluate the feasibility of the two Section 108 activities that failed to meet a national objective and determine the eligibility of the \$15,814,000 already invested. Any amount determined ineligible must be reimbursed to the program from non-federal funds.

HUD Response:

The discussion of the two projects appears to conflate the national objectives criteria and the applicable public benefit standards. Compliance with each set of requirements must be evaluated separately. Our review of available information indicates that each project appears to comply with the national objectives criteria and the public benefit standards.

Auditee Comments

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Comment 8

Loan number B-08-MC-47-0006 (Memphis, Tennessee):

The Section 108 office has followed up directly with the City of Memphis (the borrower), on the information reflected on page 6 of the draft report. The City noted that the project had created 244 full time equivalent (FTE) jobs of the 566 FTE jobs projected to be created by the project as of the November 2016 report from the project developer. Of these jobs, 62% (152 FTE jobs) were held by low- and moderate-income persons. The City anticipates that the project will continue creating jobs through the end of the City's 2018 program year.

Comment 8

Based on these current job numbers, the City's project is expected to meet the national objective of benefit to low- and moderate-income persons through job creation, as approved in its application for loan guarantee assistance. As described above, *even if this activity were to create no further jobs*, it will have met the criteria under 24 CFR 570.208(a)(4), having created jobs of which "at least 51 percent will be held by, or be made available to, low- and moderate-income persons."

Comment 8

The Section 108 office also notes that while the City of Memphis projected a total 566 FTE jobs would be created by the development, it is not required to create at least 566 FTE jobs in order to demonstrate compliance with the public benefit standards for individual activities at 24 CFR 570.209(b)(3). This calculation is distinct from the calculation used to determine national objective compliance, as all jobs created or retained by an activity are accounted for in this calculation, not just low- and moderate-income jobs. With \$9,914,000 in Section 108 assistance, the City projected that this activity would create one FTE job per \$21,049 in Section 108 assistance, which is well below the maximum amount of \$50,000 per job permitted under the regulations. Thus, even if the activity did not create any additional FTEs, as it is projected to do, HUD notes that based on the current number of FTE jobs created, this activity has already created one job per \$40,631 in Section 108 assistance, which is well below the maximum amount of assistance per full-time equivalent, permanent job created or retained that is permitted at 24 CFR 570.209(b)(3)(i)(A).

As noted in 24 CFR 570.209(b)(4)(ii), the individual activity public benefit standards in paragraph (b)(3)(i) "shall be applied to the number of jobs to be created or retained, ... as determined at the time funds are obligated to the activities." Accordingly, the Section 108 office determines compliance with this standard during its review of the Section 108 application (i.e., in advance of the approval of the application), which is at the time the grantee's most recent grant agreement is amended to include Section 108 funding. Therefore, HUD determined the City would meet this requirement prior to approval of the Section 108 application.

This determination, however, does not relieve the Section 108 recipients from the requirement to maintain sufficient records to demonstrate the level of public benefit that is actually achieved upon completion of the assisted activities and how that compares to the level of benefit anticipated when the Section 108 funds were obligated. As provided at 24 CFR 570.209(d), if the actual results of economic activities undertaken by a CDBG recipient show a pattern of substantial variation from anticipated results, the recipient must take all actions reasonably within its control to improve the accuracy of its projections. If the actual results demonstrate that

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Evaluation**

Auditee Comments

the recipient has failed the public benefit standards, HUD may require the recipient to meet more stringent standards in future years as appropriate.



Images of the renovated Pyramid, re-opened as a Bass Pro store in Memphis, Tennessee

Loan number B-11-MC-26-0025 (Lansing, Michigan):

Comment 9

CPD also notes that the draft report's analysis that B-11-MC-26-0025 loan for \$5.9 million to the City of Lansing, Michigan, did not fully meet a national objective is incorrect. The Section 108 office clarifies that the referenced activity undertaken by the City with the Section 108 guaranteed loan funds is still ongoing. While the City has completed the renovation of the historic building downtown, it is continuing to lease-up the commercial space in the building. The Section 108 office has confirmed with the City that the building is currently at 51 percent occupancy and has created a total of 173 FTE jobs to-date, out of a total 188 permanent and part time jobs created. Thus, even if the activity did not create any additional FTEs, as it is projected to do, HUD notes that based on the current number of FTE jobs created, this activity has already created one job per \$34,104 in Section 108 assistance which is well below the \$50,000 maximum amount of assistance per full-time equivalent, permanent job created or retained that is permitted at 24 CFR 570.209(b)(3)(i)(A). At the time of application for program funds, the City had projected that the activity would create a total of 230 jobs and has stated that it is still on track to reach this projection. Moreover, as the assisted business is located within an area that qualifies for presumptive benefit, meaning that all jobs created by the business will be considered to be jobs held by, or made available to, low- and moderate-income (LMI) persons in accordance with 24 CFR 570.208(a)(4)(v). Therefore, 100 percent of jobs that have been and will be created through this activity will be presumed to be LMI jobs. Based on this information, the use of the \$5.9 million in guarantee loan funds will meet the stated national objective of benefit to low- and moderate-income persons upon completion.

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Images of the renovated Knapp Building in downtown Lansing, Michigan

Conclusion

Therefore, CPD notes that each of these activities, based on the jobs already created, will meet a national objective and that the \$15,814,000 in questioned costs are eligible. Moreover, both of these activities represent best practice projects, as both projects have generated hundreds of jobs for low- and moderate-income individuals and served as catalytic investments in the downtowns of two cities.

Recommendation 1B. Require the borrowers to submit a plan for how they will proceed and use the \$8,694,000 in unused commitments to provide intended benefits and meet program objective.

HUD Response:

In response to this draft recommendation, CPD needs to clarify that communities receiving commitments for guaranteed loan funds under the Section 108 program are not required to borrow any of the funds for which they have received a commitment. Moreover, communities have five years from the date of HUD's approval of a commitment to issue promissory notes under the commitment, depending on the source year of the associated credit subsidy appropriation. For example, a community may apply for a Section 108 commitment for a particular project that at a later date becomes infeasible due to the loss of another source of project financing. Under such circumstances, HUD cannot require this community to issue a promissory note—which serves as a debt obligation—for an infeasible project.

In particular, \$1.2 million and \$7.44 million unused portions questioned by the OIG of the \$1.8 and \$10 million respective loan commitments were to be used as economic development loan funds. CPD emphasizes that communities using guaranteed loan assistance to capitalize loan funds for the provision of assistance to businesses and to economic development projects must underwrite applicant projects prior to the provision of guaranteed financing to third parties. Therefore, communities may be left with a portion of unused commitment because the projects

Comment 10

Auditee Comments

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Comment 10

and businesses which applied for funding did not represent an appropriate risk for the community to finance or simply because the pipeline of projects is more limited than originally projected.

The primary consideration regarding unused commitments is whether HUD had already maximized the use of funding available under that respective fiscal year Congressionally-authorized amount. Both of the B-10 loan commitments referenced by the OIG report were approved by HUD in fiscal year 2011 and therefore both expire on September 30, 2017. HUD did not receive applications for loan commitments that exceeded its authorized amount that year, and, therefore, it cannot be argued that the approval of commitments for these communities had any adverse impact on the program or other communities. Furthermore, since these communities never issued promissory notes or received loan advances for these remaining funds, HUD was never even required to disburse the accompanying credit subsidy funds from the Section 108 program account to the financing account as required by the Federal Credit Reform Act of 1990.

CPD also believes it is important to provide some additional context regarding the B-10-UC-12-0004 commitment for a loan fund project. The community receiving this commitment, Palm Beach County, has successfully deployed over \$20.28 million in economic development financing through loan funds. HUD also notes that while the OIG report states that this community has only borrowed \$2.55 million of its available \$10 million, this community has informed the Section 108 office that it intends to borrow and advance the remaining balance of its commitment, \$7.44 million, within the next several months. The County has provided the Section 108 office with information on the pipeline of projects that will be funded with the remaining funds available. In light of this information, a judgment of the ultimate use of this commitment at this time is pre-mature.

Recommendation 1C. Require the borrower to provide all supporting documentation and evaluate the allowability and eligibility of \$75,000 used for the unauthorized activity. Any amount determined ineligible must be reimbursed to the program from non-Federal funds.

HUD Response:

Based on the information provided, CPD will require the borrower, Rockland County, to provide all supporting documentation for the \$75,000 in questioned costs. The Section 108 office conducted a conference call on March 20 with HUD New York Regional Office staff and Rockland County staff to request this additional information.

By June 1, 2017, CPD will review the supporting documentation in order to make a determination regarding the allowability and eligibility of the activity under Section 108 program requirements.

Recommendation 1D. Develop procedures directing field offices to include the review of Section 108-funded activities when performing the annual reviews of Block Grant recipients.

Comment 11

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Comment 1

HUD Response:

CPD clarifies that Field Offices do perform an annual review of the Consolidated Annual Performance and Evaluation Report (CAPER) for every CDBG recipient, including those with outstanding Section 108 guaranteed loan activities. Each Field Office uses the CAPER Completeness Checklist, which has been attached to this response as *Attachment 3*, to review the CAPER reports submitted by grantees. While this checklist does not include specific references to Section 108 guaranteed loan financing, Section 108 financial information and accomplishments are treated in the CAPER report like other CDBG funded activities. The data is pulled from IDIS into the CAPER report. Program income reporting, including Section 108, is done through IDIS reporting (such as the PR26 report) and not through the CAPER itself.

In general, however, CPD is in agreement that the current risk assessment process should be evaluated for possible enhancement as it relates to the number of points assigned for outstanding Section 108 guaranteed loans, especially for loan guarantees that may represent the administration of funding that is multiple times a grantee's annual CDBG award. However, CPD cannot commit to an increase in points at this time since such changes must be made via the departmental clearance process. As noted in an earlier section, CPD also agrees that current procedures for tracking and monitoring performance and compliance by Section 108 borrowers is inadequate and must be supplemented with additional processes by the Section 108 office. The additional steps CPD is taking are described in more detail below.

Based on the information provided in the OIG report, CPD will review the most recent guidance provided to the field offices for monitoring, *CPD Notice 14-04: Implementing Risk Analyses for Monitoring CPD Programs in FY 2015 and 2016*¹ to determine whether it adequately accounts for the risk associated with a grantee having an outstanding Section 108 loan within its portfolio of CPD program fund. The Risk Notice is intended to augment the Departmental policy contained in Handbook 1840.1, Rev-3, -Departmental Management Control Program, which requires the development of risk-based rating systems for all programs and Handbook 6509-2 Rev.-6, Community Planning and Development Monitoring Handbook. The purpose of the Risk Notice is to provide a consistent methodology for conducting risk analyses for CPD's formula and competitive grantees and to establish monitoring priorities within available resources. If CPD determines that this guidance should be enhanced to better account for Section 108s, it will evaluate the feasibility of updating this guidance for future fiscal years based on available budget resources and capacity as any updates require it to go through a departmental clearance process.

As noted in an earlier section, CPD has issued a revision of the *CPD Monitoring Handbook 6509.2* that includes an updated Section 108 monitoring exhibit, Exhibit 5-1 (*Attachment 4*), for use by field offices in conducting on-site monitoring that includes a new section on reporting. This exhibit includes several new questions related to the reporting of information, including program income and accomplishment data in IDIS as well as compliance with contract security and monthly account statement requirements.

¹ This notice is applicable until it is changed.

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Comment 12

CPD will continue to use a risk assessment process to best target available monitoring resources across the suite of CPD programs. We will also examine how to better assess the risk associated with Section 108 guaranteed loans and provide better tools to field office staff for ongoing oversight but it is infeasible for field offices to conduct on-site monitoring of all Section 108 loan guarantees on an annual basis.

Recommendation 1E. Develop procedures to ensure that the information necessary to monitor program performance and compliance with program requirements is promptly provided to the field offices.

CPD agrees that the information necessary to monitor performance and compliance must be collected and then made available to field offices. Much of the information needed by field offices is now, or will be, available in IDIS. As noted above, the CPD Notice currently in clearance will provide detailed guidance to recipients on utilizing IDIS as now required.

The following additional actions are on track to be completed in 2017 and will be made available for use by both the Section 108 office and field offices.

Loan Tracking Database

The Section 108 office is in the final development stages of a new Microsoft Access database loan tracking system. This database will replace the current data tracking tools (a legacy database and multiple spreadsheets) with a unified system. This enhanced system will allow for more robust data tracking and monitoring. The Section 108 office anticipates the rollout of the system in the next quarter.

The system will be used to track loans from the receipt of application throughout the ongoing servicing and monitoring of the loan. The system has been developed to capture eligibility and national objective data on loan level basis as well as underwriting information, including the required security documentation to be submitted to the document custodian and to HUD. The Section 108 office will be expanding data reporting capabilities and allowing for better tracking of milestones for items related to security and collateral documents. The Section 108 office will have the ability to track specific collateral and security documents included receipt and effective life timelines. The Section 108 office will also be able to better track and review performance of the loans via tracking of monthly account balance statements and payment history. This new system will also allow for easier transfer of data and auditing by all staff.

MicroStrategy/Oracle Report Portal

Section 108 will be working with OBGA and contractors to deploy a portal to allow for customized reporting of IDIS data via MicroStrategy reporting suite. This is a new feature recently available for the program office. It will allow the program to create customized data queries and reporting to more effectively monitor Section 108 loan and grantee performance as required. CPD anticipates rollout of the reporting portal in FY 2017. This will enhance CPD's ability to refine existing reports in IDIS and create additional reporting capability for the first time for the program. This will be a critical step in allowing the program office to enhance their desk review capabilities in further efforts to track and mitigate program risk (both performance and compliance based risk metrics) on an annual and ad hoc basis.

Comment 12

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Comment 13

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The Section 108 office will also have access to run IDIS data queries and reporting on an ad hoc basis via access to the systems via Oracle client access. This will allow for generic reporting and specific ad hoc requests on a variety of levels ranging from specific activity up to national rollup data. This will allow for more enhanced review of loans and performance integration with IDIS and the program office operations for auditing and monitoring.

Recommendation 1F. Implement procedures to ensure that borrowers comply with all loan contract provisions and that required documents are submitted, including bank agreements, monthly statement, and security documents. If a borrower does not provide evidence that it has complied with all program requirements, HUD must declare a loan default under paragraph 11 of the loan contract and initiate remedial actions under paragraph 12 of the contract.

HUD Response:

The Section 108 office has taken several actions to further its procedures to ensure that future Section 108 borrowers comply with all loan contract provisions and documentation requirements. The Section 108 office has integrated these new procedures into its operations, starting immediately following approval of the commitment for the loan guarantee. By informing Section 108 borrowers of these requirements prior to the development or execution of any of the loan financing documents, the Section 108 office can ensure greater compliance with loan contract provisions long-term.

Updated Headquarters Application Review Checklist

Beginning in fiscal year 2016, the Section 108 office updated its Headquarters Application Review Checklist (See *Attachment 5*). While many of the questions in prior version of checklist questions remain, the Section 108 office added specific questions in order to gather the information that will be used to populate the fields in the new Loan Tracking Database. For example, Question 15a. asks “does the applicant identify the source(s) of repayment? List sources of repayment (e.g. project revenue).” This information, when migrated into the Loan Tracking Database will assist the Section 108 office to run reports for loans which were expected to have project revenue or Section 108 program income—and therefore, should be filing an account statement for a Loan Repayment Account (LRA) and be reporting Section 108 program income (“SI”) in IDIS.

Post-Approval Teleconference

Starting last fiscal year, the Section 108 office added a “Post-Approval Teleconference” to immediately follow approval of any new loan guarantee commitment. Each loan officer schedules the call to occur typically within one to three weeks of the approval date and requests that the program staff as well as the finance staff and legal counsel attend the call as well as the respective Field Office CPD director and representative. The Section 108 office has developed both an external and internal, annotated version of the call agenda (See *Attachments 6 and 7*). During this teleconference, the loan officer apprises the borrower staff and Field Office staff of various security requirements, including information on the requirement for a document

Auditee Comments

custodian, and provides more general information on reporting requirements and the process for developing contract documents and advancing funds.

Updated transmittal letter for financing package and pre-financing teleconference

The Section 108 office recently completed a comprehensive revision to the transmittal letter that notifies the borrower of the loan documents that HUD has developed for a particular project or loan fund (See *Attachment 8*). The revised version of the letter now contains specific, captioned sections that outline specific requirements included in the Section 108 Contract for Loan Guarantee Assistance. The second section, which is captioned, "Contract/Financial Account Attachments," notes "The Borrower should also return fully executed letter agreements with a depository financial institution (Attachment 1 and Attachment 2, if applicable, to the Contract)." Another one of the captioned paragraphs, titled "Security Documents" notes:

"Please review the requirements in Part II, paragraph 15 of the Contract, which identify the security documents to be delivered to HUD and/or a document custodian. If the Borrower is required to establish a Custodial Account for certain documents by this paragraph of the Contract, the Borrower must provide HUD with an original fully executed Custodial Agreement prior to HUD's guarantee of the Note."

Following the transmittal of this letter and the loan documents, the Section 108 office is establishing a second teleconference to walk borrowers as well as CPD Field Office staff through the information highlighted by the transmittal letter to ensure borrowers have a full understanding of the requirements in the loan contract. The Section 108 office is working to formally integrate this process into its procedures and has drafted an initial internal teleconference agenda to use as a guide.

Updated procedures prior to provision of new Section 108 guarantees

In particular, the Section 108 office has instituted a new policy that no new Section 108 promissory note will be guaranteed without prior receipt of the bank agreement for the Guaranteed Loan Funds account and an executed custodial agreement, if applicable.

Moreover, the Section 108 office has also developed a revised "Security Document Checklist" to replace a previous version of this checklist in order to formalize this process (See *Attachment 9*). The checklist, which is filled out by the loan officer originating loan, is then used by management to review the loan financing package prior to guarantee and then by the Section 108 Loan Management Team to follow-up on any outstanding security documents.

The revised checklist, unlike the prior version, organizes the required documents by the stage in which they are required. Hence, any documents, such as executed custodial agreement, that are required prior to HUD's guarantee of the Note, are listed in a specific section. Management will not concur on the documents included in the financing package, including the Contract and Guarantee, if these documents are not noted as received and included in the background tab of the concurrence package.

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Additionally, this revised checklist lists which documents that HUD must receive following the guarantee of the promissory note and clarifies whether HUD must receive original documents or copies. Following the guarantee of each note, the loan officer will provide the checklist to the Section 108 Loan Management Team, which will immediately enter the information on a centralized spreadsheet and follow-up on the remaining required security documents within a specific timeframe as will be defined in the Section 108 office's policies and procedures, which are currently under development.

CPD Notice developed to clarify IDIS reporting requirements for Section 108 borrowers

As noted above, the Section 108 office has developed a draft CPD Notice, CPD 17-024, on the subject of reporting requirements in IDIS for Section 108 loan guarantee recipients which is currently undergoing CPD departmental clearance (See *Attachment 10*). The clearance period closed on March 22, 2017. The guidance provides a step-by-step overview for how grantees can ensure compliance with the reporting requirements for financial transactions and accomplishments for the eligible activities undertaken with Section 108 guaranteed loan funds.

Updated guidance and procedures for monthly statement reporting

The Section 108 office has recently developed a guideline document for borrowers to help clarify and increase accuracy and response rates for the submission of monthly account statements (See *Attachment 11*). This document provides detailed information on data required, the preferred method of submission of the information, and how the statements should be submitted via electronic format to the Section 108 office for processing. The Section 108 office has also reviewed and enhanced internal policy to better track and verify month statements as they are received and begun a transfer process from paper to electronic archival this fiscal year for all monthly statement reports received and will be using an electronic storage process moving forward. The Section 108 office is also working to integrate the report information into our tracking system to allow for better verification and continuity with submitted collateral and security documentation. Entry into the tracking system will enable better reporting on non-compliant borrowers and to allow for trend analysis on funding drawdown to be performed and to identify other utilization issues related to expenditure of funds.

While CPD is already implementing new procedures, CPD does not agree with the second part of the draft recommendation. HUD is not required to declare a loan default under paragraph 11 of the Section 108 contract and initiate remedial actions under paragraph 12 of the contract if a Borrower does not provide evidence that it has complied with all loan contract provisions.

If HUD determines that a Borrower is not in compliance with the contract through monitoring or oversight procedures, HUD is not required to declare a loan in default under paragraph 11 of the loan contract, particularly if the noncompliance is technical or non-monetary in nature (e.g., failure to submit an agreement, monthly statement, or custodian's receipt of security documents). To require a declaration of default and initiation of contract remedies in every instance of technical noncompliance goes beyond the express language of HUD's loan contracts and program remedies in 24 CFR part 570, is inconsistent with HUD's management and oversight of the program under OMB Circular No. A-129, Policies for Federal Credit Programs and Non-Tax

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Receivables (“OMB A-129”), is inconsistent with the practice of commercial lenders in the private sectors, and raises the potential for litigation.

The express language in paragraphs 11 and 12 of HUD’s loan contracts does not mandate a declaration of default by HUD or an initiation of remedial actions in response to every borrower violation. Instead, the language is permissive, providing the Secretary with the option, at the Secretary’s sole discretion, to declare a default and subsequently initiate remedial actions in the event of a borrower’s failure to comply with provisions of the loan contract. The language in paragraphs 11 and 12 is in all loan contracts and is language that has been deemed appropriate by the Secretary pursuant to statutory authority for the Section 108 Loan Guarantee Program, which authorizes the Secretary to contract with respect to obligations guaranteed under the program upon such terms and conditions as the Secretary deems appropriate. This language protects HUD in the event of borrower default, but also provides HUD with the flexibility to identify an otherwise acceptable workout without immediately declaring default and resorting to more severe remedial actions like acceleration of the note, or withholding guarantees or advances, when HUD is faced with technical, non-monetary violations of contract provisions that may not present an unacceptable risk. As an alternative to actions under paragraphs 11 and 12 under the loan contract, the Secretary may make determinations and pursue sanctions available in the CDBG grant program. Pursuant to 24 CFR 570.708, CDBG Entitlement borrowers are subject to the performance review procedures in 24 CFR part 570, subpart O and states are subject to 24 CFR §570.495 or 24 CFR §570.496. In both instances, the Secretary may pursue appropriate actions in response to performance deficiencies in the use of guaranteed loan funds (or program income derived therefrom) or violations of the loan contract.

Additionally, the Section 108 office is required to manage and oversee the Loan Guarantee Program in accordance with OMB A-129. OMB A-129 requires HUD to manage the Loan Guarantee Program’s progress towards achieving policy goals within acceptable risk thresholds, while taking action where appropriate to increase efficiency and effectiveness. Moreover, OMB A-129 indicates that successful management and oversight should be designed to achieve the program policy objectives while minimizing undue risk and cost to the taxpayer, and that they should reflect the program’s scope, policy goals, and risks.

Title I of the Housing and Community Development Act of 1974, as amended, sets forth the statutory purposes applicable to the Loan Guarantee Program, the primary objective of which is the development of viable urban communities, by providing decent housing and a suitable living environment and expanding economic opportunities, principally for persons of low and moderate income. While CPD appreciates the OIG’s interest in increasing the efficiency and effectiveness of the program, CPD believes that the recommendation that HUD declare default and initiate contract remedies for any borrower violation does not reflect an appropriate consideration of the program’s policy objectives. When faced with technical or non-monetary violations, a policy of immediately declaring default and initiating contract remedies would have the effect of undermining program participation and detracting from the program’s progress towards achieving policy goals. Furthermore, an automatic default policy could unnecessarily increase financial risk to the Federal government in cases when borrowers plan to repay Section 108

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guaranteed loans over an extended period with annual CDBG grant funds, but may not have the ability to payoff acceleration of the debt if they do not yet have access to future CDBG grant allocations.

Lastly, the Section 108 office notes that the recommendation that HUD must declare a loan default under paragraph 11 of the loan contract and initiate remedial actions under paragraph 12 of the contract upon any evidence of noncompliance with the loan contract is inconsistent with commercial lending practice in the private sector and has the potential to result in action by HUD that may result in litigation. Commercial lenders do not always declare default and accelerate debt or foreclose on collateral, particularly when faced with technical or non-monetary violations of loan agreements.

Moreover, if HUD's were to declare defaults and seek contract remedies, including the acceleration of debt, in response to technical or non-monetary violations, courts may not sustain HUD's actions if they were challenged by borrowers. While the controlling law on defaults, acceleration, and foreclosure depends on a number of factors, including the jurisdiction and the collateral in question, various courts have evaluated the fairness of declarations of default, acceleration, and foreclosure in accordance with principles of equity. In some instances, courts have barred acceleration and foreclosure as inequitable, notwithstanding the terms and conditions contained in agreements between parties, where the initial default was technical or minor and did not impair the secured parties' security interest. This recommendation requiring a declaration of default and initiation of contract remedies in every instance of technical noncompliance exposes HUD to unnecessary litigation risk.

Notwithstanding that CPD does not agree that declaring a default in all cases is appropriate, CPD does believe that noncompliance with any program or contract requirements requires corrective action that is appropriate and proportionate to the violation. Such action would be designed to prevent a continuation of the performance deficiency; mitigate, to the extent possible, the adverse effects or consequences of the deficiency; and prevent a recurrence of the deficiency.

Recommendation 1G. Develop and implement a tracking system for monitoring reviews of Section 108 loans.

HUD Response:

Comment 15

As noted in earlier sections, the Section 108 office is in the final development stages of a new Microsoft Access database loan tracking system. This database will replace the current data tracking tools (a legacy database and multiple spreadsheets) with a unified system. While this system along with the other systems and procedural enhancements described in the above sections will ensure that the Section 108 can provide field offices with additional reports and more robust information for monitoring reviews of Section 108, CPD already has systems in place for tracking monitoring reviews of Section 108 loans, such as ARCATS and GMP.

Auditee Comments

List of Attachments:

- Attachment 1 Response to Identified Deficiencies Table
- Attachment 2 Field Offices Update
- Attachment 3 CAPER Screen Based Checklist – August 2016
- Attachment 4 Exhibit 5-1 HUD Monitoring Guide
- Attachment 5 HQS Application Review Checklist rev. 10-27-2016
- Attachment 6 Post Approval Teleconference External Agenda
- Attachment 7 Post Approval Teleconference Guide Internal
- Attachment 8 Entitlement DPA Example of Revised Transmittal Letter
- Attachment 9 Security Document Monitoring Checklist
- Attachment 10 IDIS Notice Final
- Attachment 11 Submission of Monthly Account Balance

OIG Evaluation of Auditee Comments

Comment 1 HUD agreed that improvements in the monitoring process of Section 108 loans were needed. It stated that it had updated CPD's monitoring handbook and would assume a greater responsibility in tracking borrowers' compliance with requirements. In addition, HUD stated that it would provide the field offices with guidance and tools to assist in assessing potential compliance issues.

We acknowledge HUD's efforts in pursuing procedural and system enhancements to improve the monitoring of Section 108 loans. HUD must ensure that the monitoring enhancements direct field offices to include the review of Section 108-funded activities when performing the annual reviews of Block Grant recipients.

Comment 2 HUD acknowledged that Section 108 borrowers did not always comply with contract requirements and stated that in 2014, program staff began a comprehensive review to identify borrowers that had not fully complied with loan contract requirements. HUD stated that reviews were underway at the Caribbean, Boston, Philadelphia, Pittsburgh, Columbus, Atlanta, Oklahoma City, Knoxville, and Hartford field offices. Reviews of all field offices were expected to be completed by the end of fiscal year 2017. HUD also stated that it had instituted new procedures to ensure that new loans would not encounter similar problems.

We acknowledge HUD's new efforts to ensure that borrowers comply with all loan contract provisions and required documents are submitted. HUD must ensure that the new procedures provide for timely followup in instances of noncompliance and initiate remedial actions against a borrower that fails to comply with all program requirements.

Comment 3 HUD stated that every loan does not require all of the bank accounts and agreements referenced in the Section 108 contract and that not every borrower is required to submit monthly statements. It stated that the draft report identified instances of missing documents for Section 108 projects, when some of the documents had been submitted and others were not required. However, HUD stated that it was working on identifying the specific instances when the statements are required and that the missing documents would be incorporated into the field office reviews.

We acknowledge HUD's efforts to identify instances of missing documents and include them in the field offices' reviews. Although HUD stated that some of the missing documents had been submitted and others were not required, no new information was provided to us, showing that the borrowers complied with loan contract requirements. All loan contracts reviewed contained the same loan provisions, making borrowers responsible for submitting the pertinent documents.

If a borrower was considered to be exempt from submitting bank agreements, statements, or other documents, the loan contract should specify this waiver. For the loans for which the documentation requirement was specified in the contract, our review tested compliance with the specific loan contract provision unless it was made clear, through our review of documentation in the file, that the requirement did not apply, in which case, it was not taken as an exception.

Comment 4 HUD agreed that additional steps were needed to ensure that activities met a national objective of the Block Grant program and stated that it intended to assign greater responsibility to the Section 108 office to supplement the field office onsite monitoring. In addition, HUD stated that it would create additional reporting capabilities for its systems, enhance desk review capabilities, and mitigate certain program risks.

We acknowledge HUD's efforts to ensure that activities meet a national objective of the Block Grant program. HUD must ensure that the enhancements to HUD's systems will assist the field offices in including the review of Section 108-funded activities when performing the annual reviews of Block Grant recipients.

Comment 5 HUD stated that for loan number B09UC360103, the borrower was not necessarily required to establish a loan repayment account because the loan would be repaid from Block Grant funds.

HUD failed to comment that the borrower comingled Section 108 funds and did not establish an individual account as required by the loan contract.

Comment 6 HUD stated that it did not rely on other collateral so long as Block Grant funds were available to cover loan repayments that become due, which was why no defaults occurred. It also agreed that it needed to remedy past noncompliance with additional security requirements.

HUD agreed that it needed to remedy past noncompliance with additional security requirements. However, it ignored the possible elimination or reduction in funding, of the Block Grant program, which could increase its risk if a borrower defaults. HUD needs to take appropriate steps and measures to minimize its risk and ensure that appropriate collateral is obtained for all Section 108 projects.

Comment 7 HUD stated that new procedures for monitoring monthly reporting requirements would address the issue of borrowers' failure to disburse guaranteed loan funds by the established deadline. It also stated that a new data tracking tool was being developed for better tracking of milestones.

We acknowledge HUD's efforts to improve monthly reporting and tracking of Section 108 loans.

Comment 8 HUD stated that the City of Memphis had created 244 full-time-equivalent jobs and anticipated that the project would continue to create jobs through the end of program year 2018. In addition, it stated that the project was expected to meet the national objective of benefiting low- and moderate-income persons through job creation, as approved in its loan application. HUD also stated that based on the current jobs created, the activity had already created one job per \$40,631 in Section 108 assistance, which is below the \$50,000 maximum amount of assistance per full-time-equivalent, permanent job created or retained.

HUD provides no support for its assertion. Therefore, it must require the borrower to provide appropriate supporting documentation to show that the hired personnel met applicable income limit requirements.

Comment 9 HUD stated that the report incorrectly states that the project of the City of Lansing did not fully meet a national objective of the Block Grant program. In addition, it stated that the activity was ongoing (the building was 51 percent occupied) and had created 173 full-time-equivalent jobs. HUD also stated that based on the current jobs created, the activity had already created one job per \$34,104 in Section 108 assistance, which is below the \$50,000 maximum amount of assistance per full-time-equivalent, permanent job created or retained. HUD stated that the project was located within an area that qualified for presumptive benefit and all jobs created by the businesses would be considered to be held by or made available to low- and moderate-income persons.

According to HUD's loan approval letter, the national objective for this project was to benefit low- and moderate-income persons through job creation and not under the presumptive benefit criteria. HUD must require the borrower to provide appropriate supporting documentation of eligible census tracts for this project to apply the presumptive benefit criteria.

Comment 10 HUD stated that communities receiving commitments for guaranteed loan funds were not required to borrow any of the funds and communities had 5 years to issue promissory notes under the commitments. In addition, it stated that it could not require a community to issue a promissory note for an infeasible project. HUD also stated that the unused commitments had no adverse impact on the program and other communities because HUD did not receive applications that exceeded its authorized amount for Section 108. HUD stated that Palm Beach County intended to borrow the remaining \$7.44 million in unused Section 108 loan commitments.

HUD commented that Palm Beach County planned to use the remaining \$7.44 million in unused commitments. However, it did not comment on whether the second borrower intended to use the \$1.2 million in unexpended commitments. We did not suggest or imply that a borrower or a community should issue promissory notes for infeasible projects. Any project approved must follow

established guidelines and meet applicable feasibility requirements. More than 3 years had elapsed since the two borrowers received funding and had not used the full approved loan amount to provide economic development loans. Although the communities might not be required to borrow funds, the borrowers submitted loan applications to HUD, stating that the Section 108 funds were needed to address special needs of its communities. No additional information was provided, showing or explaining why the borrowers no longer needed the Section 108 funds. HUD must require the two borrowers to submit a plan, stating how they will proceed and use the unused commitments to address community needs and meet program objectives.

- Comment 11 HUD stated that it would require the borrower to provide supporting documentation for \$75,000 in questioned costs. HUD further stated that it would review supporting documentation and make a determination regarding the allowability and eligibility of the activity.

We agree with HUD's course of action.

- Comment 12 HUD agreed that the information necessary to monitor performance and compliance of Section 108 loans must be collected and made available to the field offices. It stated that was implementing modifications to HUD's systems to have information available to field offices.

We acknowledge HUD's efforts in pursuing procedural and system enhancements to improve the monitoring of Section 108 loans.

- Comment 13 HUD stated that it had taken several actions to ensure that borrowers comply with loan contract provisions and documentation requirements. It had initiated procedural enhancements to improve the monitoring of Section 108 loans.

We acknowledge HUD's new efforts to ensure that borrowers comply with all loan contract provisions and required documents are submitted. HUD must ensure that the new procedures provide for timely followup in instances of noncompliance and initiate remedial actions as determined appropriate when a borrower fails to comply with all program requirements.

- Comment 14 HUD did not agree with the declaration of a default in every instance of technical noncompliance. It believed that its loan contract did not require a declaration of defaults by HUD or an initiation of remedial actions in response to every borrower violation. In addition, HUD stated that the recommendation was inconsistent with commercial lending practices and could expose it to unnecessary litigation risk. However, HUD stated that instances of noncompliance with any program or contract requirement should require corrective action that is appropriate and proportionate to the violation.

We acknowledge HUD's concern and have modified the recommendation. The recommendation was modified to read as follows: "Implement procedures to ensure that borrowers comply with all loan contract provisions and that required documents are submitted, including bank agreements, monthly statements, and security documents. If a borrower does not provide evidence that it has complied with all program requirements, HUD must initiate appropriate remedial actions under paragraph 12 of the contract."

Comment 15 HUD stated that it had initiated procedural and system enhancements to better track the monitoring of Section 108 loans. In addition, it stated that CPD already has the Audit Resolution and Corrective Action Tracking System (ARCATS) and the Grants Management Process system (GMP) for tracking monitoring reviews of Section 108 loans.

We acknowledge HUD's effort to implement a loan-monitoring tracking system. However, ARCATS and GMP do not provide sufficient information to identify whether a specific Section 108 loan was monitored. Any tracking system that HUD implements should include sufficient information to show when a specific loan was monitored.

Appendix C

2008-16 HUD OIG Reports Regarding Section 108

Item	Audit report number	Report date	Report title
1	2009-NY-1001	Nov. 7, 2008	The City of Newburgh, New York, Needs to Make Improvements in Administering Its Section 108 Loan Guarantee Program
2	2009-NY-1009	Mar. 6, 2009	The City of Yonkers, New York, Had Weaknesses in the Administration of its Section 108 Loan Guarantee Program
3	2011-NY-1004	Dec. 21, 2010	The City of Binghamton, NY, Did Not Always Administer Its Section 108 Loan Program in Accordance With HUD Requirements
4	2012-LA-1005	Mar. 13, 2012	The City of Los Angeles, CA, Did Not Expend Brownfields Economic Development Initiative and Section 108 Funds for the Goodyear Industrial Tract Project in Accordance With HUD Requirements
5	2014-AT-1801	Mar. 20, 2014	Vieques Sports City Complex, Office of the Commissioner for Municipal Affairs, San Juan, PR, Section 108 Loan Guarantee Program
6	2014-AT-0801	Sept. 18, 2014	HUD's Monitoring of the Vieques Sports City Complex's Section 108 Loan Guarantee Program
7	2015-AT- 1001	Dec. 5, 2014	The Office of the Commissioner for Municipal Affairs Needs To Make Improvements in Administering Its Section 108 Loan Guarantee Program
8	2016-AT-1002	Dec. 17, 2015	The Municipality of Toa Alta, PR, Did Not Properly Administer Its Section 108 Loan Guarantee Program
9	2016-NY-1003	Feb. 5, 2016	City of Rochester, NY Community Development Block Grant Program
10	2016-NY-1007	Mar. 30, 2016	The City of Jersey City, NJ's Community Development Block Grant Program Had Administrative and Financial Control Weaknesses

Appendix D

Most Common Deficiencies From HUD OIG Reports Regarding Section 108 Loan Guarantee Program

National Objective (7):

- **2009-NY-1001, *The City of Newburgh, NY*** - The City did not ensure that the commercial site, known as Crystal Lake, was feasible for commercial development and job creation.
- **2009-NY-1009, *The City of Yonkers, NY*** - The City did not establish adequate procedures to obtain and verify documentation showing that loan recipients complied with loan job creation and retention provisions.
- **2011-NY-1004, *The City of Binghamton, NY*** - The City could not provide adequate supporting documentation showing that the Regency Hotel Section 108 loan activity met a national objective of the program. In addition, the City could not provide adequate documentation to support the number of jobs created by the Hotel DeVille Section 108 loan activity.
- **2012-LA-1005, *The City of Los Angeles, CA*** - The City used Section 108 loan funds for an unapproved project; therefore, funds were not available for eligible projects to meet the national objectives of the loan and grant programs.
- **2014-AT-1801, *Vieques Sports City Complex, Office of the Commissioner for Municipal Affairs, San Juan, PR*** - The Office of the Commissioner for Municipal Affairs did not ensure that the Municipality completed a Section 108 Loan Guarantee program project to construct a sports complex.
- **2015-AT- 1001, *Office of the Commissioner for Municipal Affairs, San Juan, PR*** - The Office of the Commissioner for Municipal Affairs did not ensure that borrowers completed three Section 108 Loan Guarantee program activities (San Lorenzo activity center, Dorado hotel facilities, Camuy hotel facilities) that showed signs of slow progress.
- **2016-AT-1002, *The Municipality of Toa Alta, PR*** - The Municipality did not ensure that it completed two Section 108 Loan Guarantee program activities that showed signs of slow progress.

Custodial Bank Account (6):

- **2009-NY-1009, *The City of Yonkers, NY*** - The loan repayment account was not properly maintained. The City maintained one repayment account in which all borrower payments were commingled. As a result, it could not individually account for each economic development loan pool and direct loan in the repayment account.
- **2011-NY-1004, *The City of Binghamton, NY*** - The City failed to establish a loan repayment account and did not maintain adequate financial and program records on the loan receivable from the developer pertaining to the extent of Block Grant funding used to repay the Section 108 debt.
- **2015-AT- 1001, *Office of the Commissioner for Municipal Affairs, San Juan, PR*** - Section 108 loan program borrowers invested the loan proceeds in certificates of deposit at local

commercial banks without ensuring that they were fully collateralized with government obligations.

- **2016-AT-1002, *The Municipality of Toa Alta, PR*** - The Municipality maintained deposits of more than \$1.4 million in Section 108 loan proceeds at a local commercial bank without ensuring that they were fully collateralized with government obligations.
- **2016-NY-1003, *City of Rochester, NY*** - The loan agreement between HUD and the City required that all funds in the guaranteed loan funds account or the guaranteed loan funds investment account be disbursed for approved activities by February 28, 2015, and that any funds remaining after that date be transferred to the loan repayment account for use in paying interest, principal, or other financial obligations or be temporarily invested until final payment and discharge of the loan indebtedness. However, City officials did not transfer any remaining funds as required.
- **2016-NY-1007, *The City of Jersey City, NJ*** - Accumulated Section 108 income from the refinancing of a guaranteed Section 108 loan was not deposited into a custodial account to guarantee the repayment of the loan as required by the loan contract.

Loan Collateral (5):

- **2009-NY-1001, *The City of Newburgh, NY*** - The City did not maintain evidence that the developer provided \$300,000 in required equity funds or that any of the other funding sources were provided before it disbursed the \$1.5 million in Section 108 and Economic Development Initiative funds to the developer.
- **2009-NY-1009, *The City of Yonkers, NY*** - The City did not inform HUD when collateral on two loans was changed. It did not notify HUD when it sold property that was pledged as collateral for a loan to a new borrower. It allowed a borrower of a loan executed through the loan pool to substitute a pledge of common stock in place of the previously approved collateral of a security interest in the property and a mortgage on a vacant waterfront parcel without notifying HUD.
- **2011-NY-1004, *The City of Binghamton, NY*** - The City failed to ensure that the borrower's personal guarantees were valid or enforceable by initially agreeing to a letter of credit guarantee that was substantially less than the amount of the loan. In addition, the City did not adequately document or support the foreclosure sale of the hotel property.
- **2015-AT- 1001, *Office of the Commissioner for Municipal Affairs, San Juan, PR*** - The Section 108 loan program borrowers did not provide additional security to assure the repayment of the debt obligation as required in paragraph 15 of the loan agreement.
- **2016-AT-1002, *The Municipality of Toa Alta, PR*** - The Municipality did not provide HUD with additional security to assure the repayment of the debt obligation as required in paragraph 15 of the loan agreement. The liens on identified properties were more than 7 years overdue and had not been filed.

Loan proceeds expenditure (4):

- **2009-NY-1001, *The City of Newburgh, NY*** - The City maintained unused Section 108 loan proceeds totaling \$652,800 in the project bank account for more than 7 years. It did not have

plans to use the funds to complete the project. Including interest, the project bank account contained more than \$752,302.

- **2015-AT- 1001, Office of the Commissioner for Municipal Affairs, San Juan, PR** - Three Section 108 loan program borrowers did not spend loan proceeds before the loan agreement deadline.
- **2016-AT-1002, The Municipality of Toa Alta, PR** - The Municipality did not spend loan proceeds before the loan agreement deadline.
- **2016-NY-1003, City of Rochester, NY** - City officials did not draw down and disburse \$6.7 million in Section 108 loan funds before the loan agreement deadline of February 28, 2015.