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Before the

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON HOUSING AND COMMUNITY
OPPORTUNITY

ON

RURAL HOUSING IN AMERICA

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INTRODUCTION

Thank you, Mr. Chairman and members of the Subcommittee. I am pleased to be here to provide testimony about the Office of Inspector General's (OIG) work on the U.S. Department of Agriculture's rural housing programs. With me today are Robert W. Young, Deputy Assistant Inspector General for Audit, and Jon E. Novak, Acting Assistant Inspector General for Investigations. I would like to submit my statement for the record and summarize the highlights for you at this time.

BACKGROUND

The U.S. Department of Agriculture's Rural Development (RD) mission area administers programs that are designed to meet the diverse needs of rural communities with a variety of loan, loan guarantee, and grant programs, including technical assistance and cooperative development. Within the RD mission area is the Rural Housing Service (RHS), which has three primary programs - Single Family Housing; Multi-Family Housing; and Community Facility programs.

RHS is responsible for providing decent, safe, sanitary, and affordable housing and community facilities in rural communities. It issues loans and grants for rural single family houses and Rural Rental Housing (RRH) apartment complexes, as well as fire stations, police stations, schools, child care facilities, libraries, hospitals, and clinics. RHS applicants may include individuals,

private organizations, and public entities. RD State offices service all 50 States and the U.S. Trust Territories, with a centralized servicing center located in St. Louis, Missouri.

For the current fiscal year (FY), authorized program funding for all RHS loans and grants totaled \$4.3 billion. For FY 2004, the proposed budget is \$5.6 billion.

OIG oversight of the Department's rural housing programs has focused on different areas over the past decade. During the 1990s, we conducted audit work in the RHS program areas of multi-family housing and single family housing. That work culminated in a joint OIG/RHS effort in 1999, addressing fraud and threats to tenant health and safety in the RRH program. Over the past several years, our audits have focused on specific issues, most often in response to Congressional and other requests. Two of these narrow scope audits have identified areas for broader audit

coverage. These include insurance coverage in multi-family housing projects and ineligible recipients for rental assistance. In addition, our desk officers continue to assess program activities and provide comments to the agency. The OIG Investigations staff has also continued to receive and pursue allegations of fraud in RHS programs.

Based on our prior and current audit and investigative work on rural housing issues, we have identified six major challenges for RHS management. These challenges include portfolio management, unallowable and excessive expenses charged to RRH projects, RRH projects leaving the program, rental assistance, allocation of funds to rural areas, and performance measures.

Portfolio Management

RHS programs provide low-cost housing to rural America. In particular, the RRH program provides low-cost apartments to residents with low incomes in rural areas. The portfolio contains over 17,000 RRH projects and 460,000 housing units, with an indebtedness of \$12 billion in loans. A substantial portion of this portfolio is over 20 years old. RHS faces a major challenge to maintain its current portfolio in good repair so that it will provide safe, decent, and affordable housing for rural America.

Unallowable and Excessive Expenses

RRH programs are vulnerable to program fraud and abuse because of the large cashflows involved. OIG has worked with RHS to address these problems and to stop those who abuse the program from participating in the program. Our March 1999 report entitled “Rural Rental Housing Program Uncovering Program Fraud and Threats to Tenant Health and Safety” described the results of a

nationwide cooperative effort involving OIG and RHS staff to identify multi-family housing owners and management agents who misused funds while neglecting the physical condition of RRH apartment complexes. Financial records reviewed by OIG Audit staff and RHS employees revealed over \$4.2 million in misused funds at apartment complexes operated by 18 owners and management agents.

We visited 637 apartment complexes and identified 145 that showed serious physical deterioration. Problems included: leaking roofs; worn, moldy, and rotted exterior siding; unsafe balconies and stairwells; unsecured hazardous materials such as gasoline; and dangerous equipment in child playground areas. In response to these findings, RHS worked with owners and management agents to resolve these serious health and safety issues.

We have found, through our audit and investigative work, that there are several common schemes used by owners and management agencies to improperly withdraw funds from RRH apartment complex accounts.

One scheme involves double-charging apartment complexes for management-related expenses that are the responsibility of the management agent and already paid through the management fee. These costs include bookkeeping, postage, and photocopying fees.

Another common scheme involves the owner or management agent charging apartment complexes for his/her own personal expenses.

Many unallowable charges are often made by identity-of-interest companies. An identity-of-interest company usually involves an owner or management official of the apartment complex who owns a side business, such as an electrical or maintenance business.

Often, ownership in the side business is not disclosed to RHS in order to hide the relationship. The side business then provides a service or sells products to the apartment complex. We have found that transactions involving identity-of-interest companies are especially vulnerable to abuse because owners and management agents originate transactions and approve them for payment. The identity-of-interest companies overcharge the RRH projects for their services or products with the RRH project suffering the loss. Further, there is no independent monitoring or approval of the payments, or other effective, compensating control to ensure the work was necessary, completed satisfactorily, and reasonably priced.

In the schemes described above, we often find that the misused funds are withdrawn from RRH project accounts. These project accounts are required by RHS so that the complexes maintain enough funds for large-scale repair and maintenance projects,

which are periodically needed (e.g., new roofing, paving of parking lots). Any time a borrower needs to utilize funds from the project accounts, he/she must obtain approval from RHS. In these equity-skimming schemes, the borrower submits fraudulent information to RHS about project account balances or charges to the project account. We have also found that local banks do not always enforce the requirement that all project account withdrawals for major capital improvements or purchases be approved and co-signed by RHS.

RHS has developed proposed regulations to address problems identified by OIG audit and investigative work. Our assessment of the regulations, as currently drafted, concluded that the proposal satisfactorily addressed 4 of the 19 audit recommendations designed to improve program integrity and safeguard project funds. We believe additional work needs to be done on the remaining 15 recommendations. Since the beginning of the joint

effort by OIG and RHS, our investigations of the multi-family and single family housing programs have led to a number of indictments, convictions, and monetary results. These cases involve schemes, as described above, which are designed to divert program funds through unallowable and excessive expenses.

RRH Projects Leaving the Program

As the RRH portfolio continues to mature, it is often in the project owners' best interest to pre-pay their loans. The majority of borrowers who received loans between 1979 and 1989 can pre-pay their loans after 20 years. The incentives for owners to pre-pay include the increasing repair costs of aging projects, loss of tax credits, and the possibility of higher rents from more affluent tenants.

As loans are pre-paid, the availability of low-income housing decreases. Therefore, RHS offers incentive payments for project

owners to stay in the program. The payments are equal to the equity value in the property at the time pre-payment is planned. To be eligible for the incentive payment, owners must maintain the property in good physical condition and must continue to serve lower-income rural residents. RHS needs to monitor incentive payments and ensure that once made, project owners continue to meet the conditions of eligibility.

Rental Assistance

The RRH rental assistance program is currently funded at \$712 million in FY 2003. This assistance makes up the difference between what tenants pay and the rental income required in order for the project owner to meet debt servicing and other costs.

Tenants receiving this assistance are generally elderly and have very low incomes. Most recipients pay only a small portion of the average \$300 monthly rent.

Currently, there are proposed regulatory changes that will require project owners to increase the balances in the RRH reserve accounts used to fund the increasing demands for repair and rehabilitation of aging projects. The increased reserves will be funded by increased rents. The basic rent for those tenants on rental assistance will not increase. To match the increased rents, the amounts of rental assistance needed to make up the difference between what the tenants pay and the actual rent necessary for the project owner to meet expenses will increase.

Allocation of Funds to Rural Areas

With the continued growth of our cities, areas that were rural just a few years ago are being taken over by urban expansion. In a 1996 audit, we found that the RHS' Single Family Housing Program was not adequately serving truly needy rural communities. We found that 9 of the 10 States reviewed used less than 13 percent of their allocated funds for loans in targeted rural areas. Our review

of the 10 States disclosed that up to 80 percent of the loans were in “bedroom” communities immediately adjacent to ineligible metropolitan areas. RHS agreed to implement controls to better ensure that targeted rural communities received adequate loan opportunities.

Performance Measures

The RD managers need accurate, relevant performance data to assess program effectiveness in accomplishing their mission. They also need strong internal controls to ensure program efficiency and effectiveness.

In March 2001, OIG evaluated the information contained in RD’s 1999 Annual Program Performance Report required by the Government Performance and Results Act. We found that in many cases, the data contained in the report were inaccurate or

unsupported. As a result, we found that the report was of little or no utility.

We believe that these problems are caused primarily by RD's lack of guidelines or procedures for accumulating, collecting, validating, and reporting performance results or for documenting the methodology for data collection. We also found that, in some cases, the items being measured were not directly related to RD's mission. Further, we found that in some cases the performance measures could not be supported.

A graphic example of the consequences of such inaccurate data is recounted in our 2001 audit report "Rural Housing Service Guaranteed Multi-family Housing Loans." In that instance, RHS reported that it had built over 6,500 units when, in fact, it had built only 222. As a consequence of this inaccuracy, \$122 million out of the total \$153 million allotted for this particular program was

unused. Had RHS had accurate data, this \$122 million could have been redirected to other projects.

It is incumbent upon management to develop internal controls and to continually evaluate their effectiveness. The Financial Managers' Financial Integrity Act (FMFIA) requires that agencies report on their systems to identify and to report on material internal control weaknesses. In March 2002, we issued a report stating that, while RD had made efforts to comply with the Act, improvements were needed to ensure material internal control weaknesses were identified, reported, and acted on. We found that in the previous 10 years, RD had found only 3 of the 23 material internal control weaknesses identified in the FMFIA report. The remaining 20 material weaknesses had been identified in either OIG or General Accounting Office reports. An effective process to identify and report material, internal control weaknesses is essential to ensure they are recognized and management actions

are undertaken to resolve the issues. Due to the complexity of RD programs, it is critical that this process operate effectively.

One example of the potential effect of unchecked material weaknesses involves the RHS multi-family housing portfolio. The agency had identified a serious lack of funding of between \$850 million and \$1 billion in its reserve accounts for repairs of multi-family housing units. However, it had not identified this as a material weakness and thus had not taken action to ensure that adequate funds would be available to pay for critical repairs to the projects. As a result, up to 25 percent of the agency's multi-family housing portfolio could become unsafe or unsanitary.

CONCLUSION

In conclusion, we believe RHS faces a number of management challenges in its efforts to deliver safe and affordable rural housing programs. RHS itself has acknowledged the challenges that we

have discussed in our testimony today. We believe the most critical challenge of the six that we have identified is the need for RD to develop accurate, relevant performance data and measures to assess program efficiency and effectiveness. Without timely and accurate information, RD will be unable to determine how well it is accomplishing its mission. Once this challenge is met, the agency will be better positioned to resolve its other management issues. OIG is committed to working with RD to help the agency be even more effective.

Later this year we will initiate an audit on the RRH program. Our review will include follow-up work to the 1999 report “Rural Rental Housing Program Uncovering Program Fraud and Threats to Tenant Health and Safety.” We will, of course, look carefully for other work that will assist the agency in meeting its management challenges.

This concludes my statement, Mr. Chairman. I would be happy to answer any questions that you may have.