AUDIT REPORT

HUD Did Not Conduct a Front-End Risk Assessment and, Therefore, Fully Implement Controls for the Public Housing Mortgages and Security Interest Program

2005-BO-0002
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OFFICE OF AUDIT, REGION 1
Boston, MA

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TO: Paula O. Blunt, General Deputy Assistant Secretary for Public and Indian Housing, P

Michael A. Motulski

FROM: for John Dvorak, Regional Inspector General for Audit, 1AGA

SUBJECT: HUD Did Not Conduct a Front-End Risk Assessment and, Therefore, Fully Implement Controls for the Public Housing Mortgages and Security Interest Program

HIGHLIGHTS

What We Audited and Why

We audited the Public Housing Mortgages and Security Interest program's process for granting security interest in $2.4 billion in as yet unappropriated Public Housing Capital Fund grants. Our 2003 audit report, 2004 BO 1004, dated December 5, 2003, on the Public Housing Capital Fund (Capital Fund) program administered by the Danbury Housing Authority, Danbury, Connecticut disclosed potential weaknesses in the U.S. Department of Housing and Urban Development (HUD) Office of Public and Indian Housing's internal controls over its Public Housing Mortgages and Security Interest program. Under the Public Housing Mortgages and Security Interest program, public housing authorities were approved to use security interests in future program grants as collateral for long-term debt instruments. Our objective was to determine whether HUD established adequate internal controls to safeguard funding before allowing public housing authorities to use security interests in future program grants.

What We Found

HUD's Office of Public and Indian Housing failed to perform a front-end risk assessment before allowing public housing authorities to use security interests in more than $2.4 billion in future Capital Fund program grants under HUD's Public Housing Mortgages and Security Interest program. This occurred because the Office of Public and Indian Housing did not believe it was necessary to perform a front-end risk assessment of the Public Housing Mortgages and Security Interest program before establishing internal controls. Without conducting a front-end risk assessment, the level of internal controls may be inadequate or ineffective. The lack of adequate internal controls created problems such as preventing HUD from establishing adequate policies and procedures for the program and from determining the proper level of HUD field office involvement required in the review, approval, and monitoring process. Furthermore, lack of internal controls led to difficulties in monitoring changes made to modernization work subsequent to HUD's approval of the work. HUD has approximately $94 million in financing proposals under review that should not be approved until a program risk assessment is completed and approved and adequate internal controls are in place.

What We Recommend

We recommend that HUD's general deputy assistant secretary for Public and Indian Housing assure that HUD

- Complete a front-end risk assessment of the Public Housing Mortgages and Security Interest program. This will result in funds to be put to better use in the amount of $4.9 million

- Establish internal controls, including rules and regulations, for the Public Housing Mortgages and Security Interest program based on results of the front-end risk assessment.

- Suspend approvals of financing proposals valued at $94 million if the front-end risk assessment is not submitted to and approved by HUD's chief financial officer by October 30, 2005.

For each recommendation in the body of the report without a management decision, please respond and provide status reports in accordance with

HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report. The auditee disagreed with our report. Based on the auditee's comments we have revised the report.

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BACKGROUND AND OBJECTIVES

The Quality Housing Work Responsibility Act of 1998, Public Law 105-276, amended the U.S. Housing Act of 1937 by consolidating the U.S. Department of Housing and Urban Development's (HUD) modernization programs. The Comprehensive Grant program and the Comprehensive Improvement Assistance program were merged into a newly created Public Housing Capital Fund (Capital Fund) program. Under the Capital Fund program, HUD awards grants noncompetitively based on a formula that considers the existing (backlog) and accrual (ongoing) modernization needs of program participants. The funds provide for capital and management activities, including modernization of public housing units, correcting physical deficiencies of public housing units, and financing and development of public housing units.

To assist HUD in accelerating the reduction in the estimated $18 billion modernization backlog, Congress legislated changes under section 516 of the Quality Housing Work Responsibility Act. The changes allow housing authorities to use security interests in future Capital Fund program grants as collateral for long-term debt instruments. The proceeds of the financing are then used by housing authorities primarily to carry out Capital Fund program modernization activities. The U.S. Housing Act of 1937 as amended in section 30 references the title for this program as "Public Housing Mortgages and Security Interest."

HUD must review and approve the financing proposals before allowing security interests in future grants. Since HUD has not published final program rules to reflect the changes in the Quality Housing Work Responsibility Act, the regulations at 24 *Code of Federal Regulations* 968 (Capital Grant program and Comprehensive Improvement Assistance program) continue to apply. In March 2005, HUD entered into a six-month agreement with a technical assistance contractor to assist in its review and approval of financing proposals. This is considered an interim measure until a larger and more extensive technical assistance contract is finalized. HUD's expectations are that the larger contract will be in place by the time the six-month contract expires.

As of May 2005, HUD had approved 38 financing proposals with a face value of more than $2.4 billion. The estimated total value of the program funds approved to date exceeds $3 billion after debt service costs are included. Debt service costs include interest, the cost of issuance, and other administrative fees.

Our overall audit objective was to determine whether the HUD Office of Public and Indian Housing established adequate internal controls to administer the Public Housing Mortgages and Security Interest program and to safeguard funding from the Capital Fund program before allowing public housing authorities to use security interests in more than $2.4 billion in future grants as collateral for long-term debt instruments.

RESULTS OF AUDIT

Finding 1: HUD Did Not Conduct a Front-End Risk Assessment and, Therefore, Fully Implement Controls for the Public Housing Mortgages and Security Interest Program

HUD's Office of Public and Indian Housing failed to perform a front-end risk assessment before allowing public housing authorities to use security interests in more than $2.4 billion[1] in future Capital Fund program grants under HUD's Public Housing Mortgages and Security Interest program. This occurred because the Office of Public and Indian Housing did not believe it was necessary to perform a front-end risk assessment of the Public Housing Mortgages and Security Interest program before establishing internal controls. Without conducting a front-end risk assessment, the level of internal controls may be inadequate or ineffective. The lack of adequate internal controls created problems such as preventing HUD from establishing adequate policies and procedures for the program and from determining the proper level of HUD field office involvement required in the review, approval, and monitoring process. Furthermore, lack of internal controls led to difficulties in monitoring changes made to modernization work subsequent to HUD's approval of the work. HUD has approximately $94 million in financing proposals under review that should not be approved until a program risk assessment is completed and approved and adequate internal controls are in place.

HUD's Attitude Delayed Completion of Risk Assessment

HUD's Management Control program mandates that a risk assessment be conducted to ascertain program risks, and, subsequently, controls be established to mitigate the most significant risks. In its response to our draft report, the Office of Public and Indian Housing stated that "although it is beneficial to go through the front-end risk assessment process to develop internal controls, it does not follow that internal controls developed outside of the risk assessment process are automatically inadequate. The Office of Public and Indian Housing believes that while there may be room for improvement, the controls implemented over the years for its approved transactions have generally been adequate". HUD's Management Control Program Handbook, chapter 8, paragraph 5A7, dictates that it is necessary as part of the risk assessment to assess management's attitude and recognition of the importance of and commitment to the establishment and maintenance of a strong system of

[1] See appendix C for a listing of the public housing authorities approved to grant security and the amounts approved.

management controls in implementing the program. If HUD's Office of Public and Indian Housing believe that controls developed outside the risk assessment process can be generally adequate, then HUD's attitude is one of the risks that need to be addressed. The Office of Public and Indian Housing delayed the risk assessment's completion because it did not feel obligated to complete the risk assessment before establishing internal controls.

HUD Lacked Adequate Policies and Procedures for Financing Proposal Requests Approved

From November 2000 through June 2003, the Office of Public and Indian Housing's Office of Policy, Programs, and Legislative Initiatives had responsibility for reviewing and approving financing proposal requests to use security interests in future grants from the Capital Fund program under the Public Housing Mortgages and Security Interest program. However, the Office began approving financing proposal requests before completing a front-end risk assessment to develop adequate internal controls, including policies and procedures, for administering the Public Housing Mortgages and Security Interest program. The Office of Public and Indian Housing provided funding to initiate a front-end risk assessment of the Capital Fund program but did not fund it through its completion. Moreover, it did not evaluate the risk or impact of using security interests from future program grants. As a result, financing proposals were approved with significant risk to the funding.

For example, the Office of Inspector General's (OIG) 2003 audit of the Capital Fund program,[2] administered by the Danbury Housing Authority (Authority), Danbury, Connecticut, indicated a lack of controls for the financing activity. Although the Authority defaulted on its bond for technical reasons, our audit determined that the Authority was not financially able to issue its $11 million bond. A cash flow analysis of the bond determined that the Authority would not have been able to repay debt service on its bond and properly maintain the physical condition of its federal properties. We estimated that the Authority would have an $8.5 million cash shortfall through 2027 related to its bonds and Capital Fund program expenditures. Had HUD performed a front-end risk assessment and established proper internal controls for the program, the problems at the Danbury Housing Authority would probably have been averted.

[2] The Danbury Housing Authority was the second authority approved under the Public Housing Mortgages and Security Interest program. The Authority has been the only housing authority thus far to default on its issued bonds.

HUD Field Offices Not Consistently Involved in the Approval Process

We determined that the Office of Policy, Programs, and Legislative Initiatives did not always coordinate the financing activities for using security interests under the Public Housing Mortgages and Security Interest program with HUD field offices. While the Office of Policy, Programs, and Legislative Initiatives was responsible for coordinating the financing activities, it processed 17 financing proposals valued at approximately $650 million. Our review showed that many of the field offices were not involved in the review and approval of these financing proposal requests. For instance, our audit of the Danbury Housing Authority found that Region 1 program officials in Boston were not aware that the Authority had submitted a financing proposal or received approval to use the security interest in future grants as collateral to secure long-term debt financing. Region 1 officials also were not aware that the Holyoke, Massachusetts, Housing Authority had received HUD approval for its financing proposal. Similarly, program officials in Kansas City, Buffalo, and Philadelphia had no involvement in evaluating or approving the security interests as collateral for public housing authorities within their jurisdictions. However, we did find that the New Orleans and Baltimore field offices participated in the review of using security interests in future program grants for public housing authorities under their jurisdictions.

The involvement of the field offices is a factor to be considered during the front-end risk assessment. Without the local program officials' involvement, HUD had little assurance that the Authority had the financial management capability to successfully participate in this program. Such involvement possibly would have prevented the default faced by the Danbury Housing Authority.

In summary, the first 17 financing proposals, valued at approximately $650 million, were not consistently approved with sufficient involvement from HUD field offices. The lack of consistent involvement by field offices indicates a risk needing mitigation under the Public Housing Mortgages and Security Interest program. In addition, HUD approved security interest as collateral without mitigating significant program risks as evidenced during our audit of the Danbury Housing Authority's Capital Fund program. Some of the risks that can occur without proper controls in place include limited assurance that housing authorities have the capacity to participate in the program and a lack of certainty whether proposals are financially viable. To date, the 17 proposals have not been fully evaluated to identify or mitigate potential program risks.

HUD Established Control Objectives without Conducting a Front-End Risk Assessment

In August 2003, the responsibility for review and approval for the financing activities for the Public Housing Mortgages and Security Interest program transitioned from the Office of Policy, Programs, and Legislative Initiatives to the Office of Capital Improvements within the Office of Public and Indian Housing. Through May 2005, the Office of Capital Improvement approved 21 financing proposals valued at $1.8 billion. The Office of Capital Improvements developed general guidelines that implemented 11 control objectives[3] for the program. However, the Office of Capital Improvements developed these controls/guidelines without completing the front-end risk assessment of the Public Housing Mortgages and Security Interest program.

Potential Risks Exist for Changes Made to Modernization Work after Approval of Financing Proposal

We determined there are potential risks regarding changes made to modernization work subsequent to HUD's approval of the financing proposal. Our audit fieldwork showed that the work outlined in the needs assessment and the proposal approved by HUD for the Woonsocket Housing Authority changed significantly after HUD approval. The needs assessment submitted to HUD with the Woonsocket Housing Authority's proposal showed the Morin Heights project, consisting of 300 dwelling units in 35 residential buildings and one community building, could be modernized for $9.2 million. However, the Woonsocket Housing Authority significantly changed the scope of construction after HUD approved the proposal. The revised scope cost $8.3 million and addressed only 14 of the 35 residential buildings or approximately 40 percent of the entire project. This change left $5.5 million in unfunded modernization for the remaining buildings.

While we recognize the Woonsocket Housing Authority for its initiative to completely redesign part of the project to create handicapped accessible units, the work was not the most economical and efficient use of these limited funds. The risk of housing authorities changing modernization work is that the changed work may not be the most economical and efficient use of

[3] See appendix E for a listing and description of the 11 control objectives.

funds and less money may be available to carry out future modernization activities for rehabilitating public housing units.

Conclusion

HUD does not have adequate internal controls for its financing activities under the Public Housing Mortgages and Security Interest program because it failed to perform a front-end risk assessment for the program. The issuance of debt has a major impact on a housing authority's financial condition and its ability to perform necessary modernization. Since the value of the financing plans is significantly larger than that of conventional modernization programs at the housing authorities, it is imperative that HUD establishes adequate controls over the program. Considering the magnitude of this $2.7 billion program, HUD's first priority should be to complete a risk assessment.

Without a risk assessment, HUD has no assurance that adequate internal controls will be developed and implemented. Under the current conditions, HUD has no assurance of what the risks are. Once HUD knows what the risks are, it can establish controls to mitigate risk. The risks identified in this report could significantly impact the mission, goals, and objectives of this program. HUD has 22 financing proposal requests under review, totaling approximately $94 million, that should not be approved until a program risk assessment is completed and adequate internal controls are in place. We determined funds to be put to better use in the amount of $4.9 million (See appendix D) based on the average costs to be repaid. This is the annual amount of funds that will be better safeguarded if a front-end risk assessment is completed and adequate internal controls are established.

Recommendations

We recommend that the general deputy assistant secretary

1A. Complete a front-end risk assessment of the Public Housing Mortgages and Security Interest program. This will result in $4.9 million in funds to be put to better use. (See appendix D).

1B. Establish internal controls, including rules and regulations, for the Public Housing Mortgages and Security Interest program based on the results of the front-end risk assessment.

1C. As part of the risk assessment process, evaluate the risk for significant changes made to modernization work after financing proposals have been approved. Also, consider defining what constitutes a significant change.

1D. Suspend approvals of financing proposals valued at $94 million if the front-end risk assessment is not submitted to and approved by HUD's chief financial officer by October 30, 2005.

SCOPE AND METHODOLOGY

Our overall objective was to determine whether HUD's Office of Public and Indian Housing established adequate controls before allowing public housing authorities to grant security interest in $2.4 billion in future Capital Fund program grants.

To accomplish our objectives, we

- Reviewed Federal requirements, including 24 *Code of Federal Regulations* part 968, "Public Housing Modernization"; section 516 of the Quality Housing Work Responsibility Act of 1998, "Public Housing Agency Mortgages and Security Interests"; and Public Law 105-276, part 1, "Capital and Operating Assistance."
- Interviewed HUD's Office of Capital Improvement staff, as well as HUD field office staff, to determine internal controls in place for financing activities.
- Reviewed documentation from prior reviews to obtain an understanding of the financing proposal process and to determine the impact on the current assignment. We extracted applicable information to be used in establishing our compliance testing.
- Summarized financing proposals, as well as proposals currently under review.
- Selected the approved bond financing proposals for review to determine whether HUD followed its own general guidelines including its 11 control objectives for approval and monitoring of financing proposals.
- Summarized and evaluated information obtained from housing authorities and HUD field offices.
- Performed an on-site review of the Woonsocket Housing Authority's bond proposal. Reviewed documents and records regarding the needs assessment and the scope of work planned at the Morin Heights project with bond proceeds. Compared data from the needs assessment with data on the work planned for the Morin Heights project.
- Reviewed the bond loan documents, specifically debt service schedules, for analysis of projected modernization backlog over the life of the debt instruments.

The audit was conducted between February 2004 and May 2005 and covered the period from January 1, 2002, through December 31, 2004. When appropriate, the audit was extended to include other periods. We conducted our audit in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

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

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

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

- Internal controls to assure proper rules and regulations are in place,
- Internal controls over the approval of financing proposals, and
- Internal controls over monitoring the activities resulting from approved financing proposals.

We assessed the relevant controls identified above.

Significant Weaknesses

A significant weakness exists if internal controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

Our review identified significant weaknesses in the internal control areas we assessed, which are described in detail in the findings section of this report. The control weaknesses include a lack of adequate

- Internal controls to assure proper rules and regulations are in place,
- Internal controls over the approval of financing proposal requests, and
- Internal controls over monitoring activities resulting from approved financing proposals.

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Unsupported 2/	Unreasonable or unnecessary 3/	Funds to be put to better use 4/
1A				$4,912,932

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or federal, state or local polices or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Unreasonable/unnecessary costs are those costs not generally recognized as ordinary, prudent, relevant, and/or necessary within established practices. Unreasonable costs exceed the costs that would be incurred by a prudent person in conducting a competitive business.

4/ "Funds to be put to better use" include quantifiable amounts that will be more efficiently used if an OIG recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. In this instance, we are reporting the annualized amounts associated with $94 million in proposals pending approval.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation | **Auditee Comments**

08/15/05 16:59 PUBLIC HOUSING PARTNERSHIP DIV → 617 565 6878 NO.557 P002/008

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-5000

OFFICE OF PUBLIC AND INDIAN HOUSING

August 15, 2005

MEMORANDUM FOR: John Dvorak, Regional Inspector General for Audit, 1AGA

FROM: Dominique Blom, Acting Deputy Assistant Secretary for Public Housing Investments, PI

SUBJECT: Draft Audit Report – HUD did not Adequately Safeguard $2.4 Billion for Granting Security Interest in Public Housing Capital Fund Program Grants or Ensure Reductions in Modernization Needs.

Thank you for the opportunity to provide comments on the draft Report regarding the Capital Fund Financing Program. This is in reply to your August 2, 2005, memorandum requesting that we provide you with comments by August 15, 2005. We recognize and appreciate that you have extended multiple opportunities to us to discuss the audit with your staff as you have developed the audit Report. The following are the requested comments.

The Report contains one finding: $2.4 billion in future Capital Fund Program grants used as collateral without demonstrating adequate internal controls were established to safeguard funding. The Office of Public and Indian Housing (PIH) does not agree with the finding. The Report contains seven recommendations. PIH agrees with five of the recommendations, disagrees with one of the recommendations and agrees with only part of one of the recommendations.

Finding:

Comment 1

Comment 2

PIH does not agree that HUD did not adequately safeguard $2.4 billion in proceeds that were secured with a portion of the affected PHA's future year Capital Fund grants or that HUD did not ensure reductions in modernization needs. While the Report contains a number of errors or technical inaccuracies that we advised you of previously, this response focuses on the underlying basis for the Report's finding rather than suggesting individual corrections.

Comment 3

Comment 4

After reading the Report, one is left with the impression that PIH approved 38 bond or loan transactions borrowing $2.4 billion with inadequate safeguards in place. The impression is inaccurate. With the exception of one errant transaction that did not follow established procedures, PIH implemented significant controls from the beginning of the processing of these 38 transactions. PIH acknowledges that the controls that were in place for the initial transactions were not formalized. However, beginning in late 2002, the procedures were formally written down in a draft notice and later in a draft regulation. Although neither has yet been published, PIH has internally implemented the controls and enhanced them over time. In fact extensive and, PIH would argue adequate, controls have clearly been in place during the approval process

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for virtually all of the 38 transactions noted in the Report.

As noted by the Report, Section 30 of the U.S. Housing Act of 1937, as amended authorizes HUD to grant a security interest in a public housing project or other property of the public housing agency. In addition, Section 9(d) of the U.S. Housing Act of 1937, as amended, makes "financing" an eligible expense under the Capital Fund. Section 30 indicates that in making such approvals, HUD will consider the ability of the public housing agency to use the proceeds, the ability of the PHA to make payments, and such other criteria as HUD may determine is necessary. There is no requirement that borrowed funds must be used to reduce the backlog of modernization need.

Comment 5

As noted by the Report, subsequent to passage of the above legislation, PIH's Office of Policy, Programs, and Legislative Initiatives (OPPLI) was initially responsible for processing requests for approval of PHA transactions to borrow private capital to be securitized by a pledge of future year capital funds (the Capital Fund Financing Program or CFFP[1]). Subsequently, PIH transferred the responsibility for the program to the Office of Capital Improvements (OCI). Close to the inception of PIH approving PHA financing requests, PIH instituted a controlled process for reviewing requests including requiring PHAs to submit financing documents associated with the transactions prior to approving any transactions. PIH staff and management experienced in financing were engaged in the approval process in a number of ways including: reviewing the financing documents; reviewing the PHA's ability to use the proceeds; and reviewing the PHA's capacity to repay the debt consistent with the requirements of Section 30. HUD's Office of General Counsel also reviewed the financing documents to ensure that applicable legal requirements were met. Finally, each transaction was reviewed and approved by the Assistant Secretary for PIH. Each transaction was thoroughly reviewed and appropriately approved consistent with the requirements of Section 30.

The Report cites an earlier Office of Inspector General (OIG) audit of the Danbury Housing Authority as the basis to determine if there were adequate internal controls. The Danbury approval was the second one in the program. PIH acknowledges that the Danbury approval was not acceptable. At the same time, that approval was made by a PIH Official who should not have provided such an approval. It was done outside of and without the knowledge of OPPLI or the Assistant Secretary. That Official is no longer with the Department. The Department has approved over 36 transactions since that time. The Report does not indicate that any of the subsequent transactions approved since 2001 were problematic approvals because of a lack of internal controls.

Comment 6

Comment 7

[1] It should be noted that the Report refers to the "Public Housing Mortgages and Security Interest program" in a number of places although the substance of the report focuses only on the transactions where PHAs are borrowing funds secured by the commitment to repay the loans (both principle and interest) from future Capital Fund grants. PIH does not use the term "Public Housing Mortgages and Security Interest program" to describe these transactions, rather it uses the term, Capital Fund Financing Program or CFFP. The Report does not cover other possible situations covered by Sections 9(d) and 30 of the U.S. Housing Act of 1937 where PHAs are entering into transactions that involve giving a security interest in something other than future Capital Fund grants.

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Comment 8

The Report does point out that a Front End Assessment (FERA) was not performed, a fact that PIH acknowledges. The purpose of the FERA is to determine the susceptibility of the program to fraud, waste and abuse. Although it is beneficial to go through the FERA process to develop internal controls, it does not follow that internal controls developed outside of the FERA process are automatically inadequate. PIH believes that while there may be room for improvement, the controls implemented over the years it has approved transactions have generally been adequate.

The Report notes that responsibility was moved from OPPLI to the Office of Capital Improvements (OCI). The Report acknowledges that, after taking administrative control of the program, OCI developed 11 control objectives that did improve the internal controls. However, the Report also indicated that those control measures did not sufficiently mitigate program risks. The Report noted that PIH had implemented the control objectives without publishing regulations.

It should be noted that the control objectives are used as a basis to review and approve PHA requests to securitize future year Capital Funds. Initially PIH enforced the control measures through communication with individual PHAs as they assembled submissions. Recently PIH put the control objectives on its web site to make them available to PHAs and program participants. The control measures communicated to PHAs include:

1. A general limitation on the amount of PHA Capital Funds pledges.
2. A general limitation on the length of the loan or bond transaction.
3. A requirement for an independent management assessment of the PHA to be performed.
4. A requirement for an independent Fairness Opinion to be issued on the extent to which the terms and conditions are fair and reasonable given current market conditions.
5. A requirements that Capital Fund statutory and regulatory requirements apply to the use of the proceeds.
6. A requirement that the debt service payments and the use of the proceeds must be included in the 5 year and annual PHA Plan approved by the local field office, pursuant to Section 5A of the U.S. Housing Act of 1937.
7. A requirement that the PHA conduct a Physical Needs Assessment as part of the CFFP process.
8. A requirement for a Field Office confirmation as to the capacity of the PHA and its support of the CFFP proposal.
9. A requirement that each property involved in the transaction must have a Declaration of Trust in favor of the Department.

These control measures are used by PIH program staff to review and recommend approval of the transactions. The Office of General Counsel reviews the transactions and must recommend approval for processing to continue. The transactions are then reviewed and recommended by the Director of the OCI and the Deputy Assistant Secretary for Public Housing Investments prior to being presented to the PIH Assistant Secretary for final approval and

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signature.

Comment 9

It should be noted that PIH has drafted regulations based on these control measures that were in Departmental Clearance at the time of this audit. At this time, the regulation has been redrafted to respond to comments received during Departmental Clearance. The OIG has not yet concurred on the regulation.

Recommendations:

Comment 10

PIH believes the existing internal controls are adequate safeguards. These safeguards are consistent with existing statutory and regulatory requirements. The Report contains seven recommendations. Three of the recommendations ask that PIH consider particular enhancements to internal controls for the program. While PIH agrees that the enhancements are beneficial, it should be noted that the enhancements address lower level risk compared to the core control measures mentioned above that are already implemented.

Comment 11

Comment 12

The Report indicated that PIH did not always follow the objectives, as indicated by a lack of field office involvement. PIH Field Offices are directly involved in current approvals contrary to the Report's assertions. The relatively few instances cited in the Report where Field Offices were not adequately involved occurred during the early implementation of the program. The instances noted should be considered a temporary aberration and not construed as a program-wide weakness. The Report does not cite any recent instances in which PIH is deviating from the current process. The Report failed to find a single instance of fraud, waste or abuse in the 38 transactions already approved other than the aberrant approval of the Danbury transaction in 2000. There is therefore no substantive documentation to support the finding that there are inadequate safeguards.

Comment 13

The Report asserts that PIH approved financing proposals that did not properly consider future long-term modernization needs or reduce the backlog of modernization needs. The Report recommends that PIH consider requesting that Congress limit the use of borrowed funds solely to eliminate long-term modernization backlog. PIH does not believe that it should seek the imposition of such a limitation.

First, such a requirement is unnecessary based on the fact that most PHAs use borrowed funds to reduce backlog modernization needs even in the absence of such a requirement. In instances where PHAs choose to undertake other activities with borrowed funds, they are generally meeting a community need that would not otherwise be met without these funds.

Second, the Report's recommendation is inconsistent with some of the fundamental principles of the public housing program set forth in Sections 2 and 5A of the U.S. Housing Act of 1937. Specifically, those sections vest in PHAs the maximum amount of authority for determining needs of individual public housing communities. Section 5A compels PHAs to develop 5 year and annual plans, in conjunction with the residents and local officials. PHAs determine the priorities for using Federal funding pursuant to PIH regulations. Section 9(d) of the U.S. Housing Act of 1937 establishes ten eligible expense categories under the Capital Fund. Those eligible expense categories permit a large number of activities that do not address

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reducing long-term modernization need including: the development of new public housing, the implementation of management improvements, expenditures to facilitate programs to improve the empowerment and economic self-sufficiency of residents, expenditures to improve the security and safety of residents, and expenditures to support homeownership activities. Furthermore as stated earlier, current law under Sections 9(d) and 30 of the U.S. Housing Act of 1937 does not require PIH to limit borrowings to solely address the backlog. As such, the Report's assertion that PIH failed to ensure that the use of the proceeds reduce the modernization backlog is inconsistent with existing Federal law. PIH is only required to ensure that borrowed funds are spent for items that are eligible under the Capital Fund program.

Comment 14

As noted above, PIH disagrees with the underlying basis for the Report's finding. While PIH does agree that controls over initial approvals could have been strengthened and that there is some room for improvement, it believes that it has had adequate safeguards and that it has improved the internal controls that apply to the CFFP approvals over time. The problems cited in the Report (the approval of the Danbury transaction and lack of Field Office involvement in some early transactions) represent aberrations that do not apply to transactions approved for the past several years. In addition PIH does not agree either that it is obligated to ensure that borrowed funds reduce the backlog of modernization need or that it should seek to limit PHA decision-making in this regard.

Recommendation. 1A: Complete a front-end risk assessment of the Public Housing Mortgages and Security Interest program.

PIH Response. PIH agrees. PIH agrees that a front-end risk assessment is appropriate at this time. PIH has finished drafting a front-end risk assessment of the entire Capital Fund including the Capital Fund Financing Program. It anticipates formal submission to HUD's Chief Financial Officer in the imminent future. We note that recommendation 1A and 1G are similar in nature, and we would ask that you consider combining the two recommendations.

Recommendation. 1B. Establish internal controls, including rules and regulations, for the Public Housing Mortgages and Security Interest Program based on the results of the front-end risk assessment.

PIH Response. PIH agrees. As discussed in this response, PIH believes that it has developed and implemented adequate internal controls for the program. However, PIH acknowledges that formal regulations should be issued. PIH has drafted regulations for the program. The regulations are currently in Departmental clearance. PIH has taken the results of the FERA process thus far into account in developing the regulations. PIH estimates that proposed regulations will be published in the second quarter of Fiscal Year 2006.

Recommendation. 1C: Consider a threshold for significant changes made to modernization after financing has been approved. If the threshold is exceeded, require approval for changes to modernization work.

PIH Response. PIH agrees. PIH will discuss thresholds with the PIH Office of Field Operations and implement for new approvals occurring 30 days after issuance of the Report.

Ref to OIG Evaluation **Auditee Comments**

Recommendation 1D: Consider implementing a control that would require applicants to provide a physical needs assessment that covers the entire period of the indebtedness with the initial application and update as necessary through out the period of indebtedness.

PIH Response. PIH agrees. PIH currently requires a physical needs assessment that covers the entire period of the indebtedness. PIH will require all submissions after the date of the issuance of the audit Report to be updated at least once every five years with the PHA Plan.

Recommendation 1E. Consider implementing a control that world require applicants to submit a performance evaluation Report with their Annual Plan that details the work performed and costs expended related to the proceeds of borrowed funds.

PIH Response. PIH agrees. PIH currently requires the debt service and the proceeds to be included in the Annual Plan and the Performance and Evaluation Report submitted by PHAs.

Recommendation 1F. Consider requesting Congress to revise legislation to provide a requirement to limit the use of borrowed funds to eliminate long-term modernization needs of public housing.

Comment 15

PIH Response. PIH disagrees. While PIH understands the importance of reducing long-term modernization needs, it does not believe that such legislation is appropriate given the fundamental principle that underlies the public housing program, namely that PHAs are to be vested with maximum decision-making authority to do what is best for their local communities. This fundamental principle is evident in Sections 2 and 5A of the U.S. Housing Act of 1937 as described above as well as in Sections 9(d) and 30. Furthermore, PIH believes such a restriction is unnecessary given that the vast majority of CFFP transactions are already targeted at reducing backlog modernization need even in the absence of such a requirement.

Recommendation 1G: Suspend approvals of financing proposals if the front-end risk assessment is not submitted to and approved by HUD's Chief Financial Officer by October 1, 2005. This will result in funds put to better use for future proposals of which $94 million are currently pending approval.

Comment 16

PIH Response. PIH agrees in part and disagrees in part. PIH has been coordinating with the Chief Financial Officer's Office (OCFO) in developing the FERA. PIH is expediting the finalization of the FERA and will submit it to the OCFO in advance of October 1, 2005. PIH disagrees with the recommendation that the program be suspended if it is not approved by October 1, 2005. PIH has no control over the length of time it will take for the Chief Financial Officer to approve the FERA; however, PIH will work cooperatively with OCFO to complete finalization by October 1, 2005. Moreover, there is the potential to do great harm if the program is suspended. Although PHAs are not required to use borrowed funds to reduce backlog modernization need, most do. In instances where PHAs choose to undertake other activities with borrowed funds, they are generally meeting a community need that would not otherwise be met without these funds.

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If you have any questions, you may contact William C. Thorson, Director, Office of Capital Improvements at (202) 708-1640 extension 4999.

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OIG Evaluation of Auditee Comments

Comment 1 The Office of Public and Indian Housing had limited assurance that these funds were adequately protected because it failed to perform a front-end risk assessment that is required in accordance with HUD regulations to identify and address risks associated with this program.

Comment 2 The Office of Public and Indian Housing implied that the report contained a number of errors or technical inaccuracies that they advised us of previously. As the Office of Public and Indian Housing confirmed in its response, we provided it multiple opportunities to discuss the audit. Based on these discussions, we corrected all the errors or inaccuracies.

Comment 3 OIG emphasized that unless a front-end risk assessment is performed for the program, the Office of Public and Indian Housing cannot adequately determine where the greatest risks are and the level of internal controls required to operate the program in an efficient and effective manner. Without the risk assessment, the implemented controls may exceed what is reasonable, and the government may be expending agency funds on unnecessary or excessive internal controls.

Comment 4 We disagree with the Office of Public and Indian Housing's claim that controls were clearly in place during the approval process for virtually all of the 38 transactions noted in the report. We were informed by Office of Public and Indian Housing staff that they had no knowledge of the circumstances by which the initial 17 transactions, approved by the Office of Policy, Programs, and Legislative Initiative, were handled. The director of the Capital Fund Division, Office of Public and Indian Housing, acknowledged that one of the causes of the problems that occurred from inception of the program was due to a lack of planning on the part of the Office of Public and Indian Housing. Therefore, it is difficult to conclude that adequate controls were in place for the initial transactions approved by the Office of Policy, Programs, and Legislative Initiatives.

Comment 5 We modified the report to remove our statements on using the borrowed funding to reduce the backlog of modernization work.

OIG Evaluation of Auditee Comments

Comment 6	The Office of Public and Indian Housing stated that the report did not indicate that any of the subsequent transactions approved since 2001 were problematic approvals because of a lack of internal controls. This statement is misleading. OIG's main focus was not to determine whether or not internal controls were in place for individual transactions. Our main concern is that because the Office of Public and Indian Housing failed to perform a front-end risk assessment, there is limited assurance that the proper level of internal controls are in place for the program in general.
Comment 7	The Office of Public and Indian Housing stated that it does not utilize the term "Public Housing Mortgages and Security Interest" to describe the program but, rather, use the term, "Capital Fund Financing Program." We recommended using the former terminology based on the U. S. Housing Act of 1937 as amended in section 30, which references the title for this program as "Public Housing Mortgages and Security Interest."
Comment 8	The Office of Public and Indian Housing stated that although it is beneficial to go through a risk assessment process to develop internal controls, it does not follow that internal controls developed outside the process are automatically inadequate. We contend that it is not only beneficial to perform risk assessments; it is required by HUD regulations and by HUD's deputy secretary. HUD's Management Control Program Handbook. Chapter 8, paragraph 5A7, entitled "Analysis of the General Control Environment Management Attitude," provides that it is necessary as part of the risk assessment to assess management's attitude and recognition of the importance of and commitment to the establishment and maintenance of a strong system of management controls in implementing the program.
Comment 9	The Office of Public and Indian Housing stated that OIG has not yet concurred on drafted regulations it submitted for the program. OIG has not concurred with the Office of Public and Indian Housing's drafted regulations because without performing a front-end risk assessment, there is limited assurance that regulations are adequate. The results of a front-end risk assessment determine what policies and regulations are needed.

OIG Evaluation of Auditee Comments

Comment 10

We disagree that the current safeguards over the program are consistent with statutory and regulatory requirements. HUD regulations require that front-end risk assessments be performed for any new program/function with funding of $10 million or more and for any substantially revised program/function with a net change in value of at least $10 million. Regulations also dictate that to meet the statutory and regulatory requirements governing internal controls, a valid risk assessment must be performed to determine the areas of greatest potential risk to the government. Without this assessment, the internal controls may be inadequate or ineffective. Further, without the risk assessment, the implemented controls may exceed what is reasonable or be ineffective, and the government may be expending agency funds on unnecessary/excessive internal controls or may not be addressing relevant risk factors.

Comment 11

The Office of Public and Indian Housing did not dispute that field offices were not always directly or fully involved in the prior approvals for proposals. Regarding current approvals, OIG did not make a specific determination regarding the current financing proposals approved. The Office of Public and Indian Housing also stated that there are few instances cited in the report in which field offices were not adequately involved. Our conclusion on the lack of field office involvement was based on a review of the initial 22 of 38 entities approved by the Office of Public and Indian Housing through April 2005. Also, we cited more than a few instances in which field offices were not directly involved in the approval process.

Comment 12

The Office of Public and Indian Housing stated that the report failed to find a single instance of fraud, waste, or abuse in the 38 transactions (financing proposals) already approved other than the approval of the Danbury public housing authority transaction in 2000. We agree that, other than Danbury, OIG did not find instances of fraud, waste, or abuse. Had the Office of Public and Indian Housing performed a risk assessment, HUD would be in a much better position to determine the program's susceptibility to waste, fraud, abuse, and mismanagement.

Comment 13

See explanation in comment 5.

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Comment 14 The Office of Public and Indian Housing stated that the Danbury public housing authority transaction and lack of field office involvement in some earlier transactions represent aberrations that do not apply to transactions approved for the past several years. OIG acknowledges that the problems at the Danbury public housing authority may represent an extreme case. However, the program is susceptible to problems occurring until a front-end risk assessment is performed to determine the level of internal controls required to operate the program efficiently and effectively.

Comment 15 See explanation in comment 5.

Comment 16 The Office of Public and Indian Housing disagreed that the program should be suspended if the risk assessment is not approved by October 1, 2005, because of concern over the time it will take the chief financial officer to approve the risk assessment. We disagree. Considering the magnitude of this program involving billions in financing, we believe the Office of Public and Indian Housing's concerns over the length of time it takes for approval of the risk assessment is unwarranted. OIG also believes that the Office of Public and Indian Housing should not proceed with this program until the completed risk assessment is reviewed and evaluated by a significant independent party.

Appendix C

SCHEDULE OF APPROVED TRANSACTIONS

Number	Housing authority	Amount	Date approved
1	Washington, DC	$33,000,000	November 2000
2	Danbury, CT	$11,000,000	December 2000
3	Kansas City, MO	$4,000,000	October 2001
4	Chicago, IL	$291,050,000	November 2001
5	Providence, RI	$5,180,000	November 2001
6	Philadelphia (A), PA	$150,000,000	May 2002
7	Syracuse, NY	$6,495,000	May 2002
8	St. Michaels, MD	$400,000	August 2002
9	Becker County, MN	$800,000	September 2002
10	Indianapolis, IN	$2,109,829	September 2002
11	East Providence, RI	$2,015,000	November 2002
12	West Haven, CT	$2,510,000	November 2002
See note below	Philadelphia (B), PA	See Philadelphia A	November 2002
13	Holyoke, MA	$825,000	December 2002
14	Roanoke, VA	$3,300,000	March 2003
15	Athens, GA	$2,700,000	June 2003
16	Alabama PHFC Pool	$130,860,000	June 2003
17	Ft. Wayne, IN	3,710,000	June 2003
Total approved by Office of Policy, Programs, and Legislative Initiatives		$649,954,829	
See note below[1]	Philadelphia (C&D), PA	See Philadelphia A	December 2003
18	Wayne County, OH	$1,125,000	December 2003
19	New Orleans, LA	$87,000,000	December 2003
20	Puerto Rico	$693,000,000	December 2003
21	Maryland Pool	$90,145,000	November 2003
22	Woonsocket, RI	$9,665,000	January 2004
23	California Pool	$10,450,000	April 2004
24	Covington, KY	$3,205,000	May 2004
25	Knoxville, TN	$21,700,000	June 2004
26	Sanford, FL	$4,000,000	June 2004
27	Dauphin, PA	$4,113,250	July 2004
28	New Bedford, MA	$15,935,000	August 2004
29	Paducah, KY	$5,970,000	October 2004
30	Schuyler, NE	$429,000	October 2004
31	Augusta, GA	$19,900,000	November 2004
32	NJ Pool	$77,855,000	November 2004
33	Tacoma, VA	$7,065,000	February 2005
34	Portland, OR	$5,950,000	March 2005
35	New York City	$600,000,000	April 2005
36	Washington (2nd appr.)	77,815,000	April 2005
37	IL Pool	25,675,000	April 2005
38	Rahway, NY	1,417,809	April 2005
Total approved by Office of Capital Improvements		$1,762,415,059	
Grand total approved		$2,412,369,888	

[1] The Philadelphia Housing Authority had three separate proposals that were only included once.

Appendix D

SCHEDULE OF PROPOSALS UNDER REVIEW AND CALCULATION OF FUNDS TO BE PUT TO BETTER USE

Number	*Housing authority*	*Bonds under review (A)*	*Term (years) (B)*	*Average Annual Repayment (A)/(B = (C)*[1]
1	Wilson, NC	$3,700,000	10	$370,000
2	Hocking Metro, OH	1,200,000	20	$60,000
3	Washburn, WI	265,000	20	$13,250
4	Stevens Point, WI	575,000	20	$28,750
5	Huntsville, AL	825,600	10	$82,560
6	Meridian, MS	8,867,208	20.90	$424,268
7	PA Pool	25,540,920	20	$1,277,046
8	Danville, IL	900,000	20	$45,000
9	Brunswick, GA	3,123,211	20	$156,161
10	Rome, GA	5,657,213	20.25	$279,369
11	Charleston, SC	8,665,346	20	$433,267
12	Beaufort, SC	585,229	20.25	$28,900
13	Spartanburg, SC	5,763,009	20	$288,150
14	Cheraw, SC	581,223	20.25	$28,900
15	Florence, SC	4,876,908	20.25	$240,835
16	Union, SC	1,424,701	20.25	$70,356
17	Aiken, SC	1,872,339	20.25	$92,461
18	Newnan, GA	2,309,079	20.25	$114,029
19	Sumter, SC	1,675,923	20.25	$82,762
20	Columbus, GA	5,202,035	20.25	$256,891
21	Decatur, GA	2,187,729	20.25	$108,036
22	Houston, TX	8,642,784	20	$432,139
	Totals	$94,440,457		$4,912,932

[1] Average Annual Repayment calculated by dividing loan amounts by term or number of years.

Appendix E

SCHEDULE OF CONTROL OBJECTIVES

Note	*Control objective*
1	Annual plan described bond financing/debt servicing and applicable modernization work
2	HUD field office involvement
3	Capital funds used as security interest did not exceed more than 33 percent of grant
4	Loan maturity limited to 20 years or less
5	Management assessment submitted
6	Fairness opinion submitted
7	Term sheet with supplemental financial information submitted
8	Loan documents submitted
9	Office of General Counsel approval
10	Office of Capital Improvement recommended approval to the assistant secretary
11	Assistant secretary signed approval letter

Explanatory Notes:

1. The inclusion of the debt servicing and modernization work allows HUD to evaluate the reasonableness of the cost of work estimates. A cost estimate is critical in determining financial viability and the impact on long-term modernization needs.

2. With the field office's firsthand knowledge of the housing authority operations, field office staff assist headquarters personnel in such tasks as evaluating whether an authority has the capacity to participate in the financing activities under the Public Housing Mortgages and Security Interest program and whether the proposals are financially viable.

3. HUD established that housing authorities could not grant security interest for more than 33 percent of future Capital Fund grants as collateral for long-term debt instruments.

4. HUD established a 20-year limitation cap for the term of debt instruments.

5. The management assessment is a third-party review to determine whether the housing authority has the ability to successfully manage the financing process and the capacity to implement the Public Housing Mortgages and Security Interest program.

6. The fairness opinion is a third-party review by a firm rendering an opinion as to whether the financing transaction proposed is reasonable and fair under current market conditions.

7. The Office of Capital Improvements requested that housing authorities provide it a term sheet. The term sheet required a rationale for financing activities verses funding with annual grants, a debt service schedule, a schedule showing the effective costs of financing, and an explanation regarding how the authority determined that grant funds remaining after payment of debt service are sufficient to fund ongoing capital needs over the life of the loan.

8. Housing authorities approved for financing under the Public Housing Mortgages and Security Interest program must submit loan documents to the Office of Capital Improvement. Some of the primary documents to be submitted include the indenture of trust agreement, pledge and security agreement, and reimbursement agreement.

9. HUD requires that the Office of General Counsel review and approve the terms and conditions of all documents.

10. The Office of Capital Improvement provides assurance to the HUD assistant secretary that HUD performed a complete and comprehensive analysis of the financing proposals.

11. The HUD assistant secretary is the approving authority for financing transactions.

Appendix F

AUDIT CRITERIA

To meet the statutory and regulatory requirements governing internal controls, a valid risk assessment of the process or program must be performed to determine the areas of greatest potential risk to the government. Without this assessment, the internal controls may be inadequate or ineffective. Further, without the risk assessment, the implemented controls may exceed what is reasonable, and the government may be expending agency funds on unnecessary or excessive internal controls.

HUD Handbook 1840.1, REV 3, “Departmental Management Control Program,” chapter 8, requires that front-end risk assessments be performed for any new program or function with funding of $10 million or more and for any substantially revised program or function with a net change in value of $10 million or more. Risk assessments are documented management reviews of a component’s susceptibility to waste, fraud, abuse, and mismanagement.

On May 16, 2003, the HUD deputy secretary issued a memorandum on risk assessments that reiterated the requirements of HUD Handbook 1840.1. The deputy secretary stated that: (1) HUD program managers “have not consistently fulfilled (the) commitment” to perform risk assessments; (2) “It is incumbent upon HUD program managers to be proactive rather than reactive in establishing adequate internal controls over (HUD) programs;” (3) HUD had committed to the performance of risk assessments as an essential component of the department’s Management Control Program, which is part of and in response to the Federal Managers Financial Integrity Act of 1982; and (4) “the application of the risk assessment concept should be applied to any significant program change as a matter of good management and business practice.”

In addition, Office of Management and Budget Circular A-123, “Management’s Responsibility for Internal Control” (revised December 21, 2004), requires that federal managers incorporate basic internal controls in the strategies, plans, guidance, and procedures that govern their programs and operations. The circular also requires that management continuously monitor and improve the effectiveness of the internal controls associated with their programs.