U.S. Department of Housing and Urban Development
Great Plains Office of District Inspector General
for Audit, 7AGA
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February 5, 1997
Audit-Related Memorandum
No. 97-KC-1120-0801

MEMORANDUM FOR: Nicolas P. Retsinas, Assistant Secretary for Housing -
Federal Housing Commissioner, H

FROM: Jose R. Aguirre, District Inspector General for Audit, 7AGA

SUBJECT: Multifamily Housing Programs
Multi-District Review of Excess Insurance Proceeds

Introduction

We conducted a multi-district review of defaulted HUD-insured mortgages financed with tax-exempt bonds. As of July 15, 1996, we found that HUD's mortgage insurance payments exceeded the funds needed to pay the underlying bonds by $17.1 million. Our objectives were to:

- Identify the amount of excess insurance proceeds
- Decide who was entitled to the excess funds
- Determine who received or was holding the excess funds
- Provide the district offices of Housing and General Counsel (OGC) the documents and information needed to assure HUD or the projects receive any misdirected or undisbursed funds.

We also evaluated: the need for regulatory changes to ensure excess insurance funds benefit the projects and ultimately the tenants; and how Housing could improve its monitoring over excess insurance proceeds.

We are recommending that Housing, in conjunction with OGC: (1) publish regulations dealing with prospective accumulations of excess insurance proceeds; and (2) take specific actions to identify excess insurance proceeds and ensure excess proceeds either benefit the housing developments and their tenants or offset HUD's mortgage insurance losses.

On January 27, 1997, the Deputy Assistant Secretary for Multifamily Programs furnished us written comments on our findings and recommendations. Those comments are included in the Appendix.

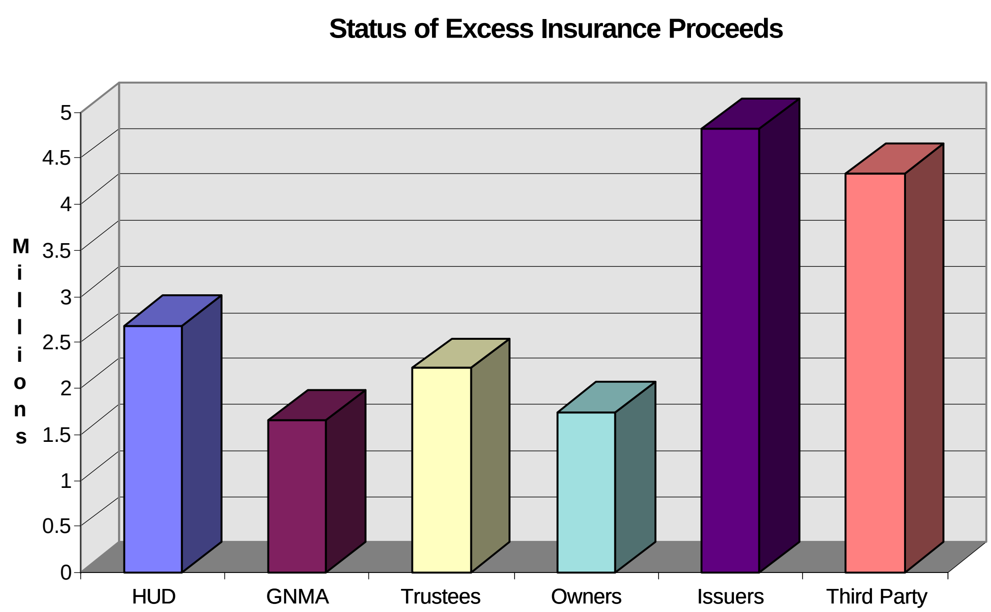
Background

Mortgagors often use tax-exempt bonds to finance multifamily housing developments with HUD-insured mortgages. When a mortgagor defaults, the mortgagee assigns the mortgage to HUD and HUD pays the mortgagee's insurance claim. On tax-exempt, bond-financed projects, the mortgagee remits funds to a bond trustee who pays off the bondholders. Frequently, HUD pays a mortgagee's insurance claim for more than is needed to pay off the outstanding bonds.

Mortgagors use two types of tax-exempt bonds, Section 103(b) and Section 11(b), to finance HUD-insured mortgages. HUD regulations implementing Section 11(b) require that any excess funds remaining in the bond debt service reserve, after redeeming outstanding bonds, must be remitted to HUD. There are no specific regulations that govern the disposition of excess funds for Section 103(b) bonds.

Audit Results

Audit work through July 15, 1996, showed HUD had paid $17.1 million in excess insurance proceeds on 82 multifamily housing developments. HUD has been successful in recovering $2.7 million. The remaining $14.4 million in excess insurance proceeds was either *disbursed* to owners, issuers, GNMA, and third parties, or *held* by trustees:



For amounts held by trustees, two districts initiated recovery steps that included persuading five trustees to file interpleaders on $1.5 million involving 14 projects. Audit work on approximately 130 multifamily projects is continuing.

Issues Resolved

During our review, we consulted with Housing and OGC and agreed that:

1. For excess insurance funds disbursed to issuers and other third parties, such as the Municipal Bond Insurance Association, OGC advised that lack of regulations governing disposition of excess insurance proceeds coupled with specific language in some trust indentures precluded HUD from either asserting a claim against the funds or requiring that the funds be returned to the project.

2. Where GNMA had recovered funds, Housing would not ask GNMA to remit funds to the insurance fund.

3. No action was necessary where owners used excess funds disbursed to them for reasonable and necessary project expenses.

4. Where mortgagors received excess proceeds and used those funds for other than reasonable and necessary project expenses, they may have violated the Regulatory Agreement and could be subject to prosecution under the Equity Skimming statutes.

Housing and OGC also agreed to take the information developed by OIG and pursue excess insurance proceeds held by bond trustees even though trust indentures were silent or vague as to ownership of the funds. In these cases, HUD will ask trustees to file an interpleader allowing HUD to assert HUD's or the project's claim and obtain a judicial decision on ownership of the excess funds. The Associate General Counsel, Office of Insured Housing, agreed to serve as the contact point and provide advice and assistance to any Assistant General Counsel experiencing difficulties in recovering excess funds for the projects or HUD.

In connection with Mortgage Note Sales, OIG suggested (and Housing and OGC concurred) to include a Reservation of Rights clause in Loan Sales Agreements. The Reservation of Rights clause preserved HUD's rights to excess insurance proceeds that remained with trustees, but were unknown to HUD or the Note Purchasers at the time of the note sale.

Issues Requiring Corrective Action

1. **Regulations Needed to Govern Disposition of Excess Funds**

We concluded Housing needs regulations to govern the disbursement of excess insurance proceeds on projects financed with Section 103(b) bonds. It makes no sense for excess insurance proceeds to be disbursed to issuers who receive reimbursement for their expenses, or to third parties such as Municipal Bond Insurance Association who receives premiums for insuring the bonds at relatively little or no risk. Excess insurance proceeds should be remitted to the project's Reserve for Replacement Account. This gives Housing the option applying the excess proceeds toward the unpaid mortgage (now held by HUD) or funding necessary project repairs.

Recommendation - 1A

We recommend the Office of Housing work with OGC and take steps to publish regulations that will require trustees to disburse to the project's Reserve for Replacement Account any excess funds remaining after bonds are paid off pursuant to mortgage default.

Housing’s Comments

Housing has agreed to pursue excess insurance proceeds where trust indentures are silent or vague and where bond trustees hold excess funds. They believe the disposition of the excess funds is dictated by the Tax Reform Act of 1986 and that the excess amounts created through payoff situations are already regulated and collected by the Internal Revenue Service. Housing has requested a legal interpretation of arbitrage rebate rules and their applicability to the excess insurance proceeds (See Appendix).

2. Multifamily Systems Need Improvement for Proactive Monitoring

In its multifamily data systems, HUD can track when a project is bond financed, but did not do so. As a result, identifying excess insurance proceeds necessitates reviewing project docket files of all projects where HUD paid a claim. Housing should capture bond financing in its data systems, require its asset managers to contact bond trustees when HUD pays a claim, and ensure trustees disburse funds appropriately.

Recommendation- 2A

We recommend Housing ensure its multifamily data systems identify bond-financed multifamily projects and establish a procedure requiring asset managers to verify that trustees disburse excess insurance proceeds appropriately.

Housing's Comments

Housing agreed to improve systems and proactive monitoring of FHA loans financed with bonds. They will endeavor to implement a tracking system by the end of fiscal year 1997.

As provided in HUD Handbook 2000.6, as revised, within 60 days please provide us with a status report for each recommendation, including corrective action taken, any proposed corrective action and the date for its completion, or why action is unnecessary. An additional status report is required on any recommendation without a management decision after 110 days. Also, please furnish us copies of any correspondence or directives issued related to this review.

We would like to thank you and your staff in Headquarters and Field Offices for their assistance and cooperation. If you have any questions about this review, please contact Jose R. Aguirre at (913) 551-5870.

Appendix