



Issue Date
November 17, 1997
Audit Case Number
98-SE-148-0001

TO: Jacquie Lawing, Acting Assistant Secretary for Community Planning and Development, D

FROM : A. George Tilley, District Inspector General for Audit, OAGA

SUBJECT: Citizen Complaint
City of Seattle
Section 108 Loan Guarantee, Acquisition of Frederick and Nelson Building,
Seattle, Washington

We reviewed complaints received from the Seattle Displacement Coalition, related to the City of Seattle's Section 108 loan guarantee for acquisition of the Frederick and Nelson building. This review focused on the regulatory and programmatic issues in the complaints.

We found that the allegations in the complaints, that the application should not have been approved, were not valid. However, the complaints identified four programmatic issues that HUD needs to address to further its efforts to empower grantees and citizens. We also identified two deficiencies in the City's administration of the Section 108 activity.

As provided in HUD Handbook 2000.6 REV-2, within 60 days, please provide us, for each recommendation in this report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued because of this review.

A copy of this report has been provided to the City of Seattle and the Seattle Displacement Coalition.

If you have any questions, please call Robert Woodard or Stan Svarc at (206) 220-5360.

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Report Number

98-SE-148-0001

Citizen Complaint

City of Seattle

Section 108 Loan Guarantee

Acquisition of Frederick and Nelson Building

Seattle, Washington

November 17, 1997

Submitted By:

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for Audit

Northwest/Alaska

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EXECUTIVE SUMMARY

We reviewed complaints submitted to the Office of Inspector General by the Seattle Displacement Coalition (SDC), related to the City of Seattle's Section 108 loan guarantee for acquisition of the Frederick and Nelson building. This review focused on the regulatory and programmatic issues in the complaints. A previous OIG investigation focused on the allegations that the City submitted false information to HUD in its Section 108 application.

Our objectives were to determine if:

- the allegations in the complaints were true: that the City's Section 108 application should not have been approved because it included inaccurate or unreliable information, and various HUD requirements were not met, and
- the complaints identified issues in the Section 108 program that HUD needs to address to make the program work better.

We found that the allegations that the application should not have been approved were not valid, and the application met HUD's requirements. However, the complaints identified four programmatic issues which HUD needs to address, which will help further its efforts to empower grantees and citizens. We also identified two deficiencies in the City's administration of the Section 108 project. To address the programmatic issues, HUD needs to:

- remind grantees that they need to explain to citizens how the assistance to for-profit businesses meets the regulatory requirement that the assistance be appropriate to carry out an economic development project,
- decide whether it should better define the criteria for spot blight, and inform grantees that use the spot blight national objective of the importance of full disclosure to its citizens about how the project meets a national objective,
- inform grantees submitting Section 108 applications of the importance of complete disclosure of pertinent facts about the project, and require compliance with HUD Reform Act disclosure requirements, and
- determine if there is a need to address citizen concerns and misconceptions about the Section 108 program through information statements or other means.

The two deficiencies in the City's administration of the Section 108 project are that the City did not:

- have documentation required by HUD regulations to support its certification that it had made efforts to obtain alternative financing for the project, and
- fully comply with statutory citizen participation requirements because it did not publish in a newspaper the proposed Section 108 application.

We are recommending that HUD address the programmatic issues, and take appropriate action regarding the two deficiencies in the City's administration of the project.

On September 29, 1997, we provided a draft of the report to the Acting Assistant Secretary of Community Planning and Development, and to the Office of Block Grant Assistance. They provided comments to the draft report in a letter dated October 27, 1997, which we incorporated into the report as appropriate. A complete copy of their response is included in Appendix A.

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Abbreviations	
HUD	Department of Housing and Urban Development
CFR	Code of Federal Regulations
CDBG	Community Development Block Grant
CPD	Community Planning and Development
FR	Federal Register
U.S.	United States

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INTRODUCTION

Background

The Section 108 program, authorized by the Housing and Community Development Act of 1974, is the loan guarantee provision of the Community Development Block Grant program. It offers communities a source of financing for housing rehabilitation, economic development, and large scale physical redevelopment projects. The applicant pledges its current and future CDBG funds as the principal security for the loan, and HUD may require additional security. The funds for the loans are not federal funds but come from notes issued by qualifying CDBG jurisdictions, and interest rates are lower because of the federal guarantee. Guaranteed loan funds may be used for various activities including loans to for-profit businesses for acquisition of real property. Grantees submit Section 108 applications to HUD, and HUD reviews and approves or disapproves each application.

Regulations governing Section 108 are at 24 CFR 570 Subpart M. The regulations include requirements that the activity undertaken with loan guarantee funds be an eligible activity and meet one of three national objectives. The regulations also require that each grantee meet the primary CDBG objective. This objective requires that over a one, two, or three year period at least 70 percent of the grantee's CDBG expenditures, including Section 108 loan guarantee funds, must benefit low and moderate income persons.

The City of Seattle (City) submitted an application on April 8, 1994 for a Section 108 loan guarantee in the amount of \$24.2 million. The application was reviewed by the HUD Washington State Office of Community Planning and Development (CPD) and sent to HUD Headquarters with a recommendation for approval. HUD Headquarters approved the loan guarantee assistance in a letter to the City dated August 5, 1994. The application stated that the Section 108 loan proceeds would be used, along with private investment, to acquire the Frederick and Nelson building in downtown Seattle, Washington, which had been vacant for about two years. A for-profit developer was to use the Section 108 loan funds to acquire the building. Funds for rehabilitation of the building were to come from private sources.

Although not stated in the application, after acquisition of the building, the developer planned to swap the building for the

property currently occupied by Nordstrom. Nordstrom was to assume the rehabilitation costs of the Frederick and Nelson building and occupy the building. The developer was to repay the loan to the City from revenues from the rehabilitated property vacated by Nordstrom. According to Seattle HUD officials, the City discussed these issues with them prior to submitting the application. Seattle CPD officials informed Headquarters officials of these issues in a letter recommending approval of the application.

The application stated that the project was to meet the national objective of eliminating spot blight, and was eligible under 24 CFR 570.203(b), assistance to for-profit businesses, acquisition.

The Committee to Save Our Neighborhoods, an ad hoc group of civic activists, initially submitted a complaint to HUD Headquarters in a letter dated March 10, 1995. HUD Headquarters, Office of Block Grant Assistance, replied to the complaint in a letter dated May 31, 1995. The letter stated that HUD did not find any basis in the complaint to revoke or otherwise cancel the loan guarantee commitment to the City. The Seattle Displacement Coalition, a low-income housing advocacy group, subsequently submitted a complaint dated November 12, 1996, to the Office of Inspector General, and four supplements dated December 12, 1996, February 14, 1997, March 20, 1997, and September 19, 1997. The individual signing the March 10, 1995 complaint to HUD was also one of the two signers of the Seattle Displacement Coalition complaint and supplements.

The Office of Inspector General completed an investigation of the November 12, 1996 complaint in December 1996. The investigation determined that there was no indication that federal criminal statutes had been violated. During the course of the investigation, the complainants provided to the Office of Inspector General a December 12, 1996 supplement to their original complaint providing additional information. Subsequent supplements to the complaint included certain new allegations and issues, including the allegation of a conflict of interest by the City's consultant who worked on the application.

The dates of important events for the application and the project are as follows:

DATE	EVENT
April 8, 1994	City submits the Section 108 application to HUD
August 5, 1994	HUD Headquarters approves the application
June 23, 1995	Nordstrom signs letter of intent to redevelop the Frederick and Nelson building
March 27, 1996	HUD guarantees promissory notes issued by the City in the amount of \$24.2 million
May 1, 1996	Date of closing on Frederick and Nelson building, transferred from seller to Nordstrom, and date City receives advances of \$24.2 million
July 1996	Nordstrom begins work on the Frederick and Nelson building. New store scheduled for opening August, 1998.

Scope and Methodology

We reviewed the Seattle Displacement Coalition's complaints against the City of Seattle regarding the City's application for a Section 108 loan guarantee to acquire the Frederick and Nelson building. We focused our efforts on those allegations that related to Section 108 program requirements. We categorized the allegations that we addressed according to various program requirements, as follows:

National objective

The project did not meet the national objective of eliminating spot blight.

Eligibility of the project

The project was not eligible for a Section 108 loan guarantee because there were competing bids for the property that would not have required a Section 108 loan guarantee.

Citizen participation

The true intent of the project was withheld from the public and from HUD, which indicates that citizen participation requirements may not have been met.

Other

The developer and Nordstrom will receive excessive profits,

Approval of the project denied use of these funds for inner-city projects where blight truly exists, and

The City's consultant who worked on the Section 108 application had a conflict of interest, because the consultant was also a director of a non-profit entity that was co-developer of a parking garage adjacent to the Frederick and Nelson building.

We did not review other allegations or issues in the complaints because they did not relate directly to the Section 108 project, or they related to the project but were not relevant to Section 108 requirements or to HUD's approval of the application.

To accomplish our objectives, we:

- reviewed the complaint and supplements to identify and evaluate the issues related to Section 108 program requirements,
- interviewed the complainants to understand their concerns, and to determine what evidence they had to support their allegations,
- reviewed records at the City's Office of Economic Development, and interviewed City officials and the City's consultant who worked on the application to understand their role and responsibilities in developing the application, and to determine if the application met HUD requirements, and
- reviewed records and interviewed HUD program staff at the Washington State HUD Office and at HUD Headquarters, to understand Section 108 program requirements including any interpretations and prior decisions on eligibility and spot blight.

Our review covered the period from the preparation of the application in early 1994 through March 1997. The investigative part of the review was performed in November and December 1996. The review of the regulatory and programmatic issues was performed from March to October 1997.

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RESULTS: Review of Allegations of Non-compliance With HUD Requirements

The initial part of our review was to determine if the allegations were true: that the City's application included inaccurate or unreliable information, and that various HUD requirements were not complied with. We determined that these allegations were not valid.

Allegation regarding national objective

The complaint and its supplements (complaints) alleged that the City deceived HUD about the national objective of eliminating slums or blight on a spot basis, because:

- the City manufactured the spot blight designation,
- crime had not increased in the area around the Frederick and Nelson building as the City claimed, which the City said resulted in an outmigration of retail stores in the area,
- there were no economic difficulties in the downtown area as claimed. The downtown area was never in decline but diverse retail shops had been driven out in favor of trendy stores catering to a wealthier clientele,
- the estimate of the number of jobs to be created by the project was inflated, and
- the findings of physical decay of the building were unreliable because they were made by Nordstrom's architect who would not have been independent.

What the application said and what the criteria requires

The City's application specified that the project to be funded under Section 108 was to meet the national objective of eliminating slums or blight on a spot basis. The application stated that the area around the Frederick and Nelson building had experienced an increase in crime, that there has been an outmigration of retail uses from downtown in the last several years, and that an estimated 1,120 new jobs would be created in the downtown area. The application also included a list of tasks and estimated costs to repair the building, as evidence of blight and physical decay.

HUD regulations require that a Section 108 project be an eligible activity such as acquisition, rehabilitation, or demolition, and that it also meet one of three national objectives. The regulations at 24 CFR 570.208(b)(2) state that under the spot blight national objective, the activity must eliminate specific conditions of blight or physical decay on a spot basis not located in a slum or blighted area. The regulations state that, in the absence of substantial evidence to the contrary, activities meeting one or more of the stated criteria (for area slums or blight and spot slums or blight) will be considered to aid in the prevention or elimination of slums or blight. The activity was to be acquisition of the Frederick and Nelson building by a private developer. After acquisition, the building was to be rehabilitated with private funds and the blighting conditions would be corrected.

What we concluded

Our review of the allegations that the City deceived HUD about the spot blight national objective showed that the allegations were not valid. The City designated the Frederick and Nelson building as meeting the spot blight criteria based on conditions of the building that constituted hazards to health and safety, and that the building had been vacant for over two years. After acquisition, the building was to be rehabilitated to eliminate the blighting conditions. HUD determined that these conditions satisfied the national objective of eliminating spot blight. We found no evidence that the City's designation of the building as meeting spot blight did not meet HUD requirements. However, we believe that the complaints identified issues regarding spot blight which HUD needs to address, as discussed in the Programmatic Issues section of this report.

- Manufactured spot blight designation

HUD officials stated that spot blight is not strictly a local determination, and that there is less guidance for the spot blight national objective than there is for slums or blight on an area basis. They said that HUD must still review and approve grantees' designations of spot blight based on HUD's experience. Therefore the City did not have complete authority to manufacture the spot blight designation.

- Crime increase

We confirmed that the crime statistics submitted with the application were not consistent in the categories of crimes reported before and after the closing of the Frederick and Nelson building. This had the effect of overstating the increase in crime in the area around the building. However, this was due to changes in the categories of crimes that were reported, and we found no evidence that the City knowingly submitted false crime statistics. Also, according to HUD officials, the crime statistics were not needed and were not a factor in HUD's approval of the loan guarantee.

- Economic difficulties

Regarding the allegation that economic conditions in the downtown area were not deteriorating as claimed by the City, there was evidence that some retailers had closed their stores, but others were opening or planning to open stores.

Indications that economic conditions downtown were in decline were that other retailers including I. Magnin, Klopfenstein's and F. W. Woolworth closed within two years after the May 1992 closure of the Frederick and Nelson building. According to City officials, conditions downtown were deteriorating in 1993 and retailers complained that the conditions were affecting shopping traffic. The City established a task force to determine how to deal with the problems, and developed a Downtown Action Plan to address the problems. An August 1994 report by a consultant, Economics Research Associates, stated that the project (development of the Frederick and Nelson building, the existing Nordstrom store, and the Systems Parking garage) was pivotal to stemming Seattle's long term decline as a retail district.

There were also indications that economic conditions downtown were improving. A newspaper article in December 1993 stated that various retailers had opened stores or planned to open stores. The article also stated that according to commercial real estate brokers and retail operators, the Frederick and Nelson building was the key to downtown, and retailers were waiting to see who landed there.

According to HUD officials, the economic conditions in the downtown area, as well as displacement of diverse

businesses in the area, were not relevant to meeting a national objective or any other program requirement. Therefore these conditions were not relevant to determining eligibility. HUD regulations for the spot blight national objective are silent regarding economic factors.

- Estimate of jobs created

The application stated that the number of jobs estimated to be created by the project was 1,120, based on a Urban Development Action Grant formula. The City's consultant who provided the estimate could not locate the source of the formula. The complainant could not explain what method should be used to make an estimate. The complainant also agreed that projecting the number of jobs was speculative at best. HUD officials stated that since assisting low and moderate income persons through jobs creation was not the national objective of the project, the estimate was not relevant to approval of the application.

- Findings of physical decay

The City's Department of Construction and Land Use requires that a building that has been vacant for more than 12 months must meet certain building standards before it can be reoccupied.

The findings of physical decay that the City submitted with its application consisted of a list of conditions at the Frederick and Nelson building that needed correcting. This list was submitted as evidence of blight or decay. The types of problems identified in the listing included the presence of hazardous materials, deterioration and damage to the exterior skin, and equipment and fixtures that dated back to 1917.

The list was prepared by an architectural firm that had worked for Nordstrom on other buildings. The complainants alleged that the firm's findings were not reliable because the firm had a conflict of interest. However, CDBG conflict of interest regulations at 24 CFR 570.611 do not prohibit the architectural firm from having an interest in the project. HUD officials stated that the City chose to use the firm, they were qualified architects, and HUD had no reason to question their use.

Allegation regarding eligibility of the project

The complaint alleged that other developers were interested in developing the project without Section 108 financing. The complaint stated that having two other offers for the property was one of the factors that made the City ineligible for Section 108 financing.

What the application said and what the criteria requires

The City submitted with the application a letter from a realtor that discussed prospective purchasers of the Frederick and Nelson building. The letter stated that the developer was one of three prospective purchasers competing to acquire the Frederick and Nelson building, and the proposed acquisition prices by the other two prospective purchasers were in the same range or greater than the final selling price. The letter did not specify the use to which the prospective purchasers would put the property. The application stated that the letter was submitted as evidence of the reasonableness of the asking price for the building.

HUD requirements, as set forth in a March 6, 1992 memorandum that provided guidance for economic development activities (the "Kondratas" memorandum), required reviewing each project cost element to determine that the cost is reasonable and consistent with third-party, fair-market prices for the cost element. Also, 24 CFR 570.704(b)(4) requires that the City certify that it had made efforts to obtain financing for activities described in the application without the use of the loan guarantee, but was unable to obtain such financing consistent with timely execution of the program. However, this requirement relates to financing of the specific project described in the application. The other offers referred to in the complaint did not specify the activity or use that the property would be put to.

What we concluded

We determined that the fact that there were other prospective purchasers of the property did not make the project that was approved ineligible. The grantee has the flexibility to decide on particular uses for properties assisted as long as program requirements are met. Also, City officials stated that the two other prospective purchasers only expressed an interest, and the selected developer was the only firm bid. HUD officials stated that a grantee can decide on a specific project and retailer if it determines that this is important to the future of the downtown area.

Allegation regarding citizen participation

The complaint alleged that the City did not disclose to HUD or to the public pertinent facts about the project, which indicates that HUD's citizen participation requirements may not have been met. Facts that were allegedly not disclosed included:

- after acquisition, the developer planned to swap the Frederick and Nelson building for property currently occupied by Nordstrom,
- the developer would also build and lease/sell to the City a parking garage adjacent to the Frederick and Nelson building and connected by a skybridge, and
- in order for the developer to make up a \$12 million deficit on the swap of the properties, the City would give the developer \$73 million up-front for a 30-year lease of the parking garage.

The complaint included a letter from a City official to a City Council member on the subject of areas of confidentiality at the upcoming public hearing on the Section 108 project. The letter stated that the City Council should avoid discussing Nordstrom's involvement and avoid linking the parking garage to the Section 108 project.

What the application said and what the criteria requires

The City's Section 108 application identified the project as the acquisition of the Frederick and Nelson building, but did not mention Nordstrom's involvement or the parking garage. HUD regulations at 24 CFR 570.704(a) address specific items that grantees must disclose in the proposed and final application. The proposed and final applications must be made available to the public. The proposed application must include the provision under which the project is eligible, the national objective to be met, the amount of guaranteed loan funds to be used, and location. The regulations state that each activity must be described in sufficient detail, including the four specific items, to allow citizens to determine the degree to which they will be affected. The regulations require that the application describe where citizens may obtain additional information about proposed activities. However, the regulations do not explain what, if any, additional information needs to be disclosed to provide sufficient detail to allow citizens to determine the degree to which they will be affected.

What we
concluded

Our review showed that the City's application submitted April 8, 1994 disclosed the four items specifically required by the regulations. Although the City's application did not mention Nordstrom's involvement or the parking garage, this information was known to the public through newspaper articles prior to the City's submission of the application. Details of the City's lease/purchase of the parking garage, including the up-front payment, were also discussed in newspaper articles when the deal was finalized in June 1995. Also, state law requires that the City hold a public hearing prior to the adoption of any ordinance relating to the leasing, acquisition, or financing of off-street parking. Such a meeting was held on February 6, 1996, at which information was available to the public on the details of the lease purchase including the up-front payment.

Seattle HUD officials stated that the information allegedly withheld was common knowledge in the community because it was written up in the newspapers, and was discussed in meetings between the City and HUD. They said that approving the application was a first step, and Nordstrom had to agree to rehabilitate the building before HUD guaranteed the loan. They stated that the determination of eligibility under the spot blight criteria was based on the Frederick and Nelson building alone.

City officials stated that they did not disclose in the application that Nordstrom would be the tenant of the Frederick and Nelson building because at that time Nordstrom had not yet committed to purchase and rehabilitate the building. They also said the parking garage was not part of the Section 108 funded project.

According to the Section 108 project developer, all parts of the total project, including Nordstrom's involvement and the parking garage, were necessary to make the project work. Also, the City's compliance with a national objective depended on Nordstrom, since they were to rehabilitate the Frederick and Nelson building and thereby eliminate the blighting conditions. In our opinion, the City's action in not disclosing these issues in the application, and in preparing the memo to the City Council about not discussing these issues, gave the public a perception that it was purposely keeping certain facts from the public. However, HUD regulations are not clear on what, if any of this information, should have been disclosed to allow citizens to determine the degree to which they will be affected. Therefore, we are including this issue as one that HUD needs to address, in the Programmatic Issues section of this report.

Allegation regarding the developer and Nordstrom receiving excessive profits

The complaint alleged that the developer and Nordstrom would receive federal and local money that they were not entitled to and would therefore receive excessive profits. The complaint stated that:

- the developer would gain at least \$18 million in public benefits, including about \$6 million because of the lower interest rate on the Section 108 loan, and
- Nordstrom would gain about \$35 million in public benefits, and would gain an unfair competitive advantage.

What the application said and what the criteria requires

The application stated that the project was eligible under 24 CFR 570.203(b) which addresses special economic development activities through the provision of assistance to a for-profit business. This regulation in the 1993 CFR, which was in effect when the application was being prepared, required that the assistance be necessary or appropriate and that an analysis be performed to ensure that the for-profit business receiving the assistance would not be unduly enriched.

There were statutory changes in this requirement in 1990 and 1992, including changing “necessary or appropriate” to “appropriate”, but these changes were not reflected in the 1993 CFR. HUD issued the “Kondratas” memorandum on March 6, 1992, which provided guidance to grantees for complying with the regulations in the provision of assistance to for-profit businesses. Although the memorandum does not use the words “undue enrichment” or require an “undue enrichment” analysis, HUD officials believe that the analyses required in the memorandum would lead the grantee through the steps required to determine if there was undue enrichment.

What we concluded

We found that the City’s application included the “appropriate” analyses that were required by the Kondratas memorandum. These included determining the reasonableness of the project

costs and assessing the public benefit. HUD officials concluded that the analyses were sufficient and that the project met this test of eligibility.

The City did not disclose the details of other projects related to the Frederick and Nelson building which were needed to make the Section 108 project feasible. These included the redevelopment of the former Nordstrom property, and the construction and lease/sale to the City of a parking garage adjacent to the Frederick and Nelson building. In our opinion, consideration of these projects was necessary in order to properly evaluate if the assistance was appropriate. However, HUD does not require that related projects be considered when making the appropriate analysis. Also, the consultant who worked on the Section 108 application for the City stated that the developer does not know what his profit on the overall project will be, if any, because there are so many uncertainties.

On the issue of profit to the developer, HUD officials stated that this is a matter of national policy. This is because the Section 108 program is designed to get for-profit businesses involved in revitalization projects, and businesses would not get involved unless they could make a profit.

On the related issue of corporate welfare, HUD officials stated that if the project meets a national objective and is eligible, it is not corporate welfare. HUD officials stated that Section 108 is a loan program not a grant program, and HUD has never had a loss in the program. Also, in a Norfolk, Virginia, U. S. District Court case that addressed corporate welfare and that involved a Section 108 loan guarantee, the court dismissed the complaint on the basis that the City could engage in anti-competitive acts, such as providing subsidies to a specific retailer, to further redevelopment projects.

Although the City met HUD's requirements in regard to determining if the assistance was appropriate, we believe that HUD needs to remind grantees of the importance of performing the "appropriate" analyses, as discussed in the Programmatic Issues section of this report.

Allegation regarding the project using scarce inner-city funds

The complaint alleges that the sole purpose of saving wealthy developers \$6 million in interest through the Section 108 program has denied use of scarce Section 108 dollars for inner-city projects in communities of color and low-income areas where opportunities are scarce and blight truly exists.

What the application shows and what the criteria requires

The application is for a \$24.2 million loan guarantee for acquisition of the Frederick and Nelson building. The project must meet one of the three national objectives of benefiting low and moderate income persons, aid in the prevention or elimination of slums or blight, or meet needs having a particular urgency. The City chose to meet the national objective of eliminating spot blight. The City must also meet the primary objective of the CDBG program, whereby not less than 70 percent of the aggregate of CDBG fund expenditures, including guaranteed loan amounts, meet the objective of benefiting low and moderate income persons.

What we concluded

We found that the allegations that the project took money away from other more needy projects, or that Section 108 funds are scarce, were not valid. The Section 108 program was designed to help local jurisdictions to leverage other community development and housing financing. The Section 108 program uses loan proceeds rather than taxpayer funds, and is generally used for activities that generate revenues for repayment of the loan. The program did not involve a subsidy until February 1995, when requirements of the Federal Credit Reform Act of 1990 were implemented. This Act required that HUD estimate future losses and request appropriations for a credit subsidy, which is an allowance for loss.

The program operates as a low-cost loan program to CDBG recipients, as opposed to the interest free grants received by the jurisdictions under the CDBG program. The funds come from the sale of notes by grantees to private investors, which have a lower interest rate because of the federal guarantee. According to HUD officials, the program has never had a default resulting in a payment by HUD on the loan guarantee. Program rules require that the grantee pledge its present and future CDBG allocations, and HUD determines if additional security is required on a case by case basis. A recent change to the program required by the

Federal Credit Reform Act is that additional security is required because of the uncertainty of future funding of the CDBG program.

Section 108 loan guarantee funds are not scarce from the point of view of amounts authorized by Congress. Congress establishes the maximum total loan guarantee authority for each fiscal year. For the six year period from 1991 through 1996, HUD approved only 39 percent of the amount authorized by Congress. Eligible grantees can apply for the loan guarantees at any time. According to HUD officials, as long as the application and the proposed project meet HUD regulations and loan guarantee authority is available, HUD has no basis for not approving the loan guarantee.

Because the Section 108 program is a loan guarantee, uses loan proceeds which must be repaid rather than CDBG grant funds or other federal funds, and because Section 108 funds are available to any grantee that meets HUD's requirements, approval of the City's Section 108 project did not result in taking money away from other uses that may have benefited low income areas.

Allegation regarding a conflict of interest

The complaint alleged that the consultant who worked on the Section 108 loan for the City had a conflict of interest. The conflict allegedly arose because the consultant is also a director of a non-profit entity that is co-developer of the parking garage adjacent to the Frederick and Nelson building.

What the application said and what the criteria requires

The application indicated that the City had secured the service of an individual who worked for the National Development Council to act as the City's agent on the Section 108 loan. The consultant had an agreement with the City, and his tasks included assisting the City in originating and monitoring Section 108 loans and CDBG float loans.

HUD conflict of interest regulations for the CDBG program, at 24 CFR 570.611, state that no grantee employee, agent, or consultant who exercises any functions or responsibilities with respect to CDBG activities, or who is in a position to participate in a decision making process with regard to such activities, may obtain a financial interest or benefit from a CDBG activity, or have a financial interest in any contract or agreement with respect to a CDBG-funded activity, either for themselves or those with which they have business or immediate family ties, during their tenure or for one year thereafter.

What we
concluded

We determined that the consultant did not violate CDBG conflict of interest regulations because he did not receive any financial benefit in his capacity as director of the non-profit entity that was the co-developer of the parking garage. A Vice President of the non-profit entity stated that directors of the non-profit 501(c)(3) entity are precluded from receiving any financial benefit. He said if this policy were to be violated, the IRS could withdraw the tax-exempt status which would cause the \$47 million in tax-exempt bonds that the entity issued for the parking garage project to become taxable. The consultant also pointed out the parking garage is not a CDBG funded activity and that there is also no conflict of interest for that reason.

Seattle HUD officials also stated that a conflict did not exist because the parking garage was not part of the Section 108 funded project.

RESULTS: Programmatic Issues

Our review of the complaints and of the current Section 108 program requirements included determining if there were ways the program could be improved to make it work better. We determined that grantees need to be reminded of their responsibilities, and they need to provide more information to the citizens about the project and about the Section 108 program. This will help carry out HUD’s priority for CPD programs that grantees and citizens be empowered to make decisions about which projects will be undertaken with Section 108 loan guarantees.

Programmatic Issue 1.

HUD needs to remind grantees to explain to citizens how the assistance to for-profit businesses meets the regulatory requirement that the assistance be appropriate.

The complaint raised the issue that the Section 108 program and local government tax breaks, as well as the developer’s involvement in other parts of the overall project, resulted in excessive profits for the developer and for Nordstrom. Similar concerns were raised in complaints from citizens on Section 108 projects in Spokane, Washington and Norfolk, Virginia. In our opinion, this indicates that grantees may not be adequately informing citizens about the Section 108 program and how their project meets program requirements.

The statute governing CDBG programs, the 1974 Housing and Community Development Act, as amended, states that eligible activities include assistance to for-profit businesses when the assistance is appropriate to carry out an economic development project. HUD regulations at 24 CFR 570.203(b) address assistance to for-profit entities. Prior to the January 5, 1995 final rule, 24 CFR 570.203(b) required an “unduly enrich” analysis. Changes to the statute in 1990, concerns about assistance to for-profit businesses resulting from Inspector General audits, oversight hearings, and other factors resulted in the March 6, 1992 Kondratas memorandum. This memorandum stressed the need for grantees to ensure that assistance to for-profit entities be appropriate. The memorandum stated that grantees that complied with it would be presumed to have met the 570.203(b) regulations. The memorandum superseded advice and guidance provided in a 1987 memorandum for the entitlement program.

The Housing and Community Development Act of 1992, enacted after the Kondratas memorandum was issued, amended the 1974 Act regarding the use of CDBG funds (including Section 108 loan guarantee funds) for economic development activities. According to a 1992 Senate Report, 102-332, the Senate Committee on Banking, Housing, and Urban Affairs concluded that there was a need to enhance the ability of grantees to use CDBG funds for economic development activities. The Committee determined that grantees had found HUD's 1987 administrative rules for the appropriateness test for economic development projects to be administratively burdensome and discouraged grantees from using CDBG funds for economic development. The Committee concluded that HUD's burdensome standards and documentation requirements had effectively prohibited or curtailed many activities which would have created significant public benefits.

The 1992 Act required HUD to establish guidelines for evaluating economic development projects, but prohibited HUD from making a project ineligible solely because the grantee failed to achieve one or more of the guidelines' objectives. As further evidence that Congress wanted HUD to give grantees flexibility in using CDBG funds for economic development, the Act also stated that HUD could not limit such assistance to activities for which no other forms of assistance were available or could not be accomplished but for that assistance.

Congress intended the CDBG program to give maximum flexibility to grantees in determining local priorities. The 1992 statutory changes to the Section 108 program gave grantees more flexibility in the use of the program for economic development. However, the statutory requirement is still in effect that assistance to for-profit businesses be "appropriate", and citizen complaints show that there is concern about excessive profits for businesses. In our opinion, grantees need to inform citizens about how the grantee determined that the assistance to for-profit businesses met the "appropriate" requirement.

HUD Headquarters CPD officials reiterated that the "appropriate" issue has been debated by Congress and the conclusion was that HUD could not use compliance with underwriting guidelines as a basis for not approving assistance to a for-profit business. They also stated that HUD is in the

process of preparing guidelines for grantees that cover risk assessments and security requirements for Section 108 projects.

These guidelines are in response to requirements of the Federal Credit Reform Act of 1990, which mandated additional security for Section 108 loans over and above the pledge of CDBG grants. These guidelines may help to address some of the concerns about the excessive profits issue.

**Programmatic
Issue 2.**

HUD should decide if it needs to better define the criteria for spot blight, and needs to inform grantees that use the spot blight national objective of the importance of full disclosure about how the project meets a national objective.

The complaint took issue with the City's use of the spot blight determination, including that the City manufactured its own definition of spot blight. The complaint stated that the City convinced HUD that one of the wealthiest pieces of real estate in the City was a slum. The complaint cited a letter written by a City official which stated, "...spot blight is whatever the City says it is." The complaint and the City's comment indicate that the citizens and grantees may not have an accurate understanding of the spot blight national objective.

The Housing and Community Development Act of 1974, as amended, and HUD regulations at 24 CFR 570.200(a)(2) state that each CDBG-assisted activity must meet one of the three national objectives. One of these is the elimination or prevention of slums or blight. The regulations state that activities meeting one or more of the listed criteria, which included preventing or eliminating slums or blight on an area basis, or eliminating slums or blight on a spot basis, in the absence of substantial evidence to the contrary, will be considered to aid in the prevention or elimination of slums or blight.

The regulations also provide some guidance for meeting the requirements for area slums or blight, including having the area meet the definition of slums or blight under state or local law. However, there is no such regulatory guidance for spot blight. The regulations state only that the activities such as acquisition, clearance, or rehabilitation which eliminate specific conditions of blight or physical decay on a spot basis will meet this objective. HUD discussed its decision not to provide regulatory standards for identifying spot blight in the preamble to the September 23, 1983 final CDBG rule. HUD recognized the "significant problems in devising any standard which specifically recognizes the prevention of slums and blight. While elimination of existing conditions of

blight can be based on a variety of objectively verifiable conditions, prevention of slums and blight is generally subjective.” HUD officials stated that, in light of the problems that a standard could pose, the decision was made to create the regulation that exists today. The premise was that eliminating specific conditions of blight or deterioration on a spot basis would prevent the spread to adjacent properties or areas.

HUD regulations at 24 CFR 570.704(c) require that HUD review and approve each Section 108 application. The regulations state that HUD can disapprove an application if the activities to be undertaken are not eligible or do not meet a national objective. HUD Headquarters CPD officials stated that the spot blight designation is not strictly a local determination, and that HUD must review and approve each such designation based on experience.

HUD Headquarters CPD officials did not believe that there was a need to better define the conditions needed to meet the spot blight national objective. They said this was because of the wide range of conditions that exist, and there needs to be room for a broad interpretation. They stated that grantees have been empowered and they should be the ones to designate spot blight. They also said that spot blight has not been an issue on other Section 108 loans.

We agree that grantees have been empowered and they should be the ones to designate spot blight to the extent possible. And we concluded that it would be a good idea for HUD to provide guidance as to the conditions that constitute spot blight which would also be consistent with or similar to its guidance on area blight.

We discussed the results of our review and the need for more guidance on spot blight determinations with HUD Headquarters CPD officials. They now agree and have decided to propose a rule for public comment that would consider whether it is desirable to give more definition to the conditions needed for an activity to qualify as meeting the spot blight component of the national objectives.

Also, in our opinion, grantees using the spot blight national objective need to get more information to the public about how the project meets a national objective. For example, the City may have included in its published notice of the first public hearing on the project, information about how the activity met a national objective. This information was in the proposed application, but the proposed application was not available until the day before the hearing. In our opinion, another important fact that grantees need to make public when using the spot blight national objective, is that they must still meet the primary CDBG objective that at least 70 percent of the total CDBG expenditures, including loan guarantee funds, benefit low and moderate income persons. When citizens know that there is a reasonable basis for the activity and that the activity meets the basic objectives of the program, they may be more likely to support the project.

**Programmatic
Issue 3.**

HUD needs to inform applicants for Section 108 assistance of the importance of complete disclosure of pertinent facts about the project, and needs to require compliance with HUD Reform Act disclosure requirements.

The complaints stated that the City did not disclose to the public and to HUD certain facts about the overall project, including Nordstrom's involvement and the parking garage. The complaints included a letter that indicated that the City did not want to have certain facts discussed at a public hearing. Information about the entire project was available in newspaper articles before the application was submitted, but not in the Section 108 application that the City was required to make public as part of the citizen participation process. In our opinion, non-disclosure of pertinent facts through the citizen participation process can raise questions and form the basis for citizen complaints.

Citizen participation is covered in the Housing and Community Development Act of 1974 under Section 104(a)(3) and in the Section 108 regulations at 24 CFR 570.704. The regulations require that each activity must be described in sufficient detail, including how it is eligible, national objective to be met, amount of funds to be used, and location, to allow citizens to determine the degree to which they will be affected.

HUD published a proposed rule on September 26, 1996, to revise citizen participation requirements for the Section 108 program. The proposed rule would conform the Section 108 regulations with the consolidated plan requirements at 24 CFR 91, using the consolidated plan citizen participation process. The proposed rule requires the same information in the proposed application as the current regulations regarding the description of the activity to be undertaken (how eligible, national objective, amount of funds to be used, and location). However, the proposed rule does not include the language that the activity be described in sufficient detail to allow citizens to determine the degree to which they will be affected.

In our opinion, the current regulations do not adequately define what needs to be disclosed to meet the test of allowing citizens to determine the degree to which they will be affected. The regulations do not make it clear whether or not disclosure of the listed items (how eligible, national objective, amount of funds, and location) is sufficient to meet the test. In our opinion, these items alone do not meet the test. We also believe that the September 26, 1996 proposed rule does not require adequate details in the proposed application so that citizens can be adequately informed.

Citizens need to have enough information about the entire project so they can decide if it meets a public purpose and if they should support or not support the project. The type of information that citizens should be provided in the application, in our opinion, includes:

- details not only of the project being funded with Section 108, but also details of the other related projects that are needed to make the Section 108 project feasible and that are needed to meet a national objective, so that the public:
 - is aware of the total extent of the project and the sources of revenue and profit for the developer,
 - knows how the national objective will be met, and
 - can help decide the corporate welfare issues.
- who will own, occupy, and rehabilitate the property, so they know who the players are.

If the application includes such pertinent details, citizens will not have to rely on other sources such as newspaper articles to form opinions or to make decisions about the project.

We noted that Section 102 of the HUD Reform Act of 1989 placed additional disclosure requirements on applicants for HUD assistance, including the Section 108 loan guarantee program.

The HUD Reform Act requirements were designed to ensure greater accountability and integrity in the provision of certain types of assistance administered by the Department. Section 102(b), Disclosure by Applicants, requires the following information from applicants for HUD assistance:

- information about assistance from other government sources that is expected to be made available with respect to the project or activities for which the applicant is seeking assistance,
- the names and pecuniary interest of any person who has a pecuniary interest in the project or activities for which the applicant is seeking assistance, and
- a report of the expected sources and uses of funds that are to be made available for the project or activity.

The final rule that provided additional information about implementation of Section 102(b) of the HUD Reform Act, became effective on the date of publication, January 16, 1992 (57 FR 1942). Therefore, the regulations were in effect in 1994 when the City prepared its application. The regulations were at 24 CFR 12 until redesignated at 24 CFR 4 in a final rule dated April 1, 1996.

Seattle HUD officials stated they were not familiar with this requirement. A City official stated that the City had not been informed about the disclosures required by the HUD Reform Act. In our opinion, if HUD had required compliance with these requirements, the City would have had to disclose all sources of funding for the project, which would have included at least part of the information that the complaint alleges was not disclosed.

HUD needs to ensure that local HUD CPD offices and grantees are aware of the HUD Reform Act disclosure requirements and that the requirements are enforced. HUD also needs to instruct the City of

Seattle to provide the required disclosures for the Section 108 Frederick and Nelson project.

**Programmatic
Issue 4.**

HUD needs to determine if it should address citizen concerns and misconceptions about the Section 108 program.

We noted from our review of the complaints against the City of Seattle's Section 108 project, as well as our reviews of complaints received on the Norfolk, Virginia and Spokane, Washington Section 108 projects, that the public and the media have concerns and misconceptions about the program. These include:

- the program appears to be corporate welfare because it benefits primarily developers and large retailers who know how to take advantage of it, and
- the program uses scarce federal funds, which prevents the use of the funds in inner-city areas where blight truly exists.

In our opinion, these types of concerns and misconceptions, if not challenged by HUD, damage the integrity of HUD and of the Section 108 program. HUD needs to have a more proactive position when its programs or activities are questioned or distorted. In addition to its fact sheets and program materials, HUD should consider the need to educate the public and the media about the program by addressing the above issues, through public information statements or other means. The statements could re-emphasize the following points:

- The Section 108 program is a loan guarantee program, not a grant program, and uses loan proceeds rather than federal funds. The program is intended to provide communities with a source of financing for leveraging economic development, housing rehabilitation, public facilities, and other large scale physical development projects. The program is generally used for projects that generate revenues that can be used to repay the loan.
- The same regulations governing the use of CDBG grants govern the use of the guaranteed loan proceeds, including national objectives, eligibility, and other requirements. Also, Section 108 funds must be included for purposes of determining that a grantee meets the test that at least 70

percent of the grantee's CDBG funds benefit low and moderate income persons.

- The program has limits on the total annual loan guarantee authority, but in only one of the last four fiscal years has the amount that HUD has actually approved been close to the amount authorized. Therefore, use of the program does not prevent the use of funds for other worthy projects that benefit primarily low and moderate income persons.
- As long as a grantee's Section 108 application and project meets all program requirements and Section 108 loan guarantee authority is available, HUD has no basis for disapproving the application.

In our opinion, the programmatic issues we identified, if addressed by HUD, will help to empower grantees and citizens. This is one of HUD's underlying principles for its CPD programs, as stated in the 1996 Consolidated Annual Report for HUD's Community Development Programs: "Today, a new emphasis on citizen participation, bottom-up planning, and program design drives CPD's internal organization and its relationship to its grantees."

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RESULTS: Deficiencies in City's Administration of the Program

During our review we identified two deficiencies in the City's compliance with Section 108 program requirements. They are summarized below.

Lack of documentation to support certification

A City official stated that the City did not have documentation to support its certification that it had made efforts to obtain alternative financing without the use of Section 108 funding but was unable to obtain such financing consistent with timely execution of the project. Section 108(a) of the Housing and Community Development Act of 1974, as amended, requires grantees to make efforts to obtain private financing, and HUD regulations at 24 CFR 570.704(b)(4) require that grantees maintain documentation of such efforts. The consultant who worked on the application for the City said he contacted lenders by phone and determined that they would not provide financing without the Section 108 guarantee, but he did not document these efforts.

The proposed application was not published

The City did not fully comply with citizen participation requirements, because it did not publish community-wide its proposed Section 108 application. The purpose of publishing the application is to afford affected citizens an opportunity to examine the application's contents and to provide comments on the proposed application (24 CFR 570.704(a)(1)(iii)).

The City published in the Daily Journal of Commerce a notice of the March 29, 1994 public hearing on the project. The notice stated that a public hearing would be held on the Mayor's proposal to apply to HUD for a Section 108 loan. The Notice did not include the proposed application but stated that application materials would be available on March 28, 1994. The Notice did not include information about the project other than that it was a Section 108 loan for acquisition of the Frederick and Nelson building.

Publication of the proposed application is a statutory requirement as well as a regulatory requirement. The regulations at 24 CFR 570.704(a)(1)(v) permit an exception to the publication requirement if the application is submitted with the entitlement grantee's submission for its entitlement grant, and if certain information on

the Section 108 activity is included. According to Seattle HUD officials, the City did not submit its application with its entitlement submission.

A City official stated that they did not interpret “publish” to mean that the entire proposed application had to be published in the newspaper. The official said they interpreted the requirement to mean that the proposed application had to be made known to the public or placed before the public. However, as stated in the preamble to the November 6, 1991 Final Rule for the CDBG Section 108 Loan Guarantee Program, the statutory requirement to “publish” refers to publication in a newspaper of general circulation, or in a state or local periodical that is similar to the Federal Register.

Recommendations

We recommend that the HUD Office of Community Planning and Development:

- 1A. Remind grantees that when they prepare applications for the Section 108 program that call for providing assistance to for-profit businesses, they need to explain to citizens how they met the regulatory requirement that the assistance is appropriate.
- 1B. Propose a rule for public comment that would consider whether it is desirable to give more definition to the condition needed for an activity to qualify as meeting the spot blight component of the national objectives.
- 1C. Remind grantees that when they prepare applications for the Section 108 program, it is important to provide citizens with sufficient information to make informed decisions about the project, without disclosing information protected by Federal, state, and local privacy laws. This information could include:
 - information about the spot blight national objective, if the grantee chose to use it, including how the proposed activity qualifies under this national objective,
 - sufficient information about the proposed activity so that citizens have a basis for evaluating it and deciding if they should support the activity, such as the following:
 - details not only of the activities to be funded with Section 108, but also details of any other related activities or proposed activities that are needed to meet a national objective and to make the Section 108 activity feasible, and
 - who will own, occupy, and develop, if applicable, the property that is the subject of the Section 108 loan.
- 1D. Instruct HUD CPD offices and grantees regarding the need to comply with the HUD Reform Act disclosure requirements, currently in 24 CFR Part 4, Subpart A (1997 CFRs), when grantees submit Section 108 applications. HUD should also take steps to ensure that the requirements are enforced.

- 1E. Decide if HUD needs to determine if there were any Section 108 applications that were submitted after the January 16, 1992 effective date of regulations implementing the HUD Reform Act disclosure requirements that did not comply with the disclosure requirements, and decide how to deal with any such cases.
- 1F. Determine if there is a need to issue a policy statement or to use other means to educate the public and the media about the Section 108 program, to help address concerns and misconceptions about the program as illustrated by the allegations in the report.
- 1G. Instruct the City of Seattle to provide evidence that it made efforts to obtain alternative financing for the activities described in the application without the use of the loan guarantee, but was unable to obtain such financing consistent with timely execution of the program, and take whatever action is appropriate if the City is unable to provide such evidence.
- 1H. Take appropriate action after evaluating the effect of the City not publishing in a newspaper its proposed application.
- 1I. Instruct the City to submit the disclosure information required by the HUD Reform Act (in 24 CFR Part 12, Subpart C, when the City prepared its application)

MANAGEMENT CONTROLS

In planning and performing our audit, we considered HUD's management controls relating specifically to our objectives, to determine our auditing procedures and not to provide assurance on management controls.

Management control is the process by which an entity obtains reasonable assurance as to achievement of specified objectives. Management controls consist of interrelated components, including integrity, ethical values, competence, and the control environment which includes establishing objectives, risk assessment, information systems, control procedures, communication, managing change, and monitoring.

We determined that the management controls relevant to our audit objectives were HUD's policies, procedures, and practices for reviewing and approving applications from grantees for Section 108 loan guarantees.

We evaluated the relevant controls. A significant control weakness exists if the controls do not give reasonable assurance that resources are used in accordance with applicable laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data is obtained, maintained, and fairly disclosed in reports.

Our review disclosed that HUD's controls over the review and approval of Section 108 applications were adequate. However, we determined that there are programmatic issues that HUD needs to address to further its efforts to empower grantees and citizens, as discussed in the Results section of this report.

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AUDITEE COMMENTS

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