



U. S. Department of Housing and Urban Development
Washington, D.C. 20410-4500
Office of the Inspector General for Audit
Northwest/Alaska
909 First Avenue, Suite 125
Seattle, WA 98104-1000
Phone 206-220-5360
Fax 206-220-5159

Audit-Related Memorandum
No: 1999-SE-148-0801

March 31, 1999

MEMORANDUM FOR: Cardell Cooper, Assistant Secretary for Community Planning and Development, D

FROM: Frank E. Baca, District Inspector General for Audit, Northwest/Alaska District, OAGA

SUBJECT: Section 108 Loan Guarantee Program
Opportunities for Improvement Identified During Review
of Complaints on Section 108 Projects in Seattle and Spokane

We completed reviews of complaints on two Section 108 projects in Washington State. In the process of reviewing the allegations in the complaints and the relevant HUD requirements, we identified opportunities for improvement in the Section 108 program which we want to bring to your attention. Addressing these opportunities may help to further the Department's missions under the HUD 2020 Management Reform Plan of empowering people and communities, and restoring the public trust.

The opportunities we identified relate to the following categories of HUD requirements or topics:

- citizen participation,
- displacement of businesses and jobs,
- presumption alternative for meeting a national objective,
- timeliness of HUD approval of Section 108 loan guarantee,
- assistance to grantees on environmental requirements,
- excess profits to for-profit businesses,
- disclosure of information by applicants,
- citizen concerns and misconceptions about the Section 108 program, and
- guidance on how an activity can qualify under the spot blight national objective.

The results of our review are included in Attachment 1.

We submitted the draft memorandum to the Assistant Secretary for Community Planning and Development and to the Director, Office of Block Grant Assistance, for comments and for suggested recommendations on November 6, 1998. We received comments from the Deputy Assistant Secretary for Grant Programs (hereinafter referred to as CPD) on January 14, 1999. CPD did not recommend action be taken on any of the new issues raised in the draft report. CPD previously provided comments and suggested recommendations on four national issues in our report on the Seattle Section 108 project. We included those issues in this report for completeness.

We reviewed and evaluated CPD's comments, deleted from the final report the issue about applicant's efforts to obtain financing without the loan guarantee, and summarized and responded to the comments for the other issues. CPD's comments are included in their entirety in Attachment 2.

We appreciate the cooperation of CPD officials in Headquarters and in the Washington State office relative to our reviews of the Seattle and Spokane Section 108 projects and the programmatic issues. We also appreciate the time and effort that went into CPD's comments on the draft reports for these reviews.

Within 60 days please furnish 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 the audit.

If you have any questions, please call Robert Woodard at 206-220-5360.

Attachments

Attachment 1 - Results

Attachment 2 - Office of Community Planning and Development comments

Attachment 3 - Distribution

Results

Background

The Northwest/Alaska District, Office of the Inspector General (OIG), received complaints on the Seattle Section 108 project starting in November 1996, and on the Spokane Section 108 project starting in December 1996. The Seattle Section 108 loan guarantee was in the amount of \$24.2 million, and was to be used for the acquisition of the Frederick and Nelson building in downtown Seattle. The Spokane Section 108 project loan guarantee commitment was in the amount of \$22.65 million to redevelop River Park Square, in downtown Spokane.

The complaints raised questions about various aspects of the projects. We limited our review of the complaints to those areas that raised questions about the Cities' compliance with HUD regulations.

We issued a report on our review of the complaints on the Seattle Section 108 project on November 17, 1997. The report included four programmatic issues which we are including in this memorandum. The report on our review of complaints on the Spokane Section 108 project was issued on September 30, 1998. We identified programmatic issues during the review of the Spokane complaints but did not include them in the Spokane report. We included in this report the programmatic issues from both reviews for completeness.

Review Objective, Scope, and Methodology

Our objective was to determine if the review of the complaints and of the applicable regulations identified opportunities for improvements in the Section 108 program. Our review covered the complaints on the Seattle Section 108 project for the acquisition of the Frederick and Nelson building, and the Spokane Section 108 project for the redevelopment of River Park Square. To accomplish our objective, we:

- reviewed the criteria for the Section 108 program to understand the regulations that apply to Section 108 applications and projects,
- reviewed the complaints and interviewed the complainants to understand their concerns and to determine what evidence they had to support the complaints,
- reviewed records and interviewed officials at the cities of Seattle and Spokane,
- interviewed Washington State and HUD Headquarters officials to understand the program, to discuss the issues, and to obtain their interpretation of certain HUD regulations, and
- reviewed the HUD 2020 Management Reform Plan and the HUD 2020 Program Services and Operations Manual to determine how the opportunities for improving the program that we identified could help HUD to carry out the Reform Plan's missions and objectives.

Opportunities for Improvement

Citizen participation

Citizen participation in the Section 108 program may need to be improved so that it becomes a process that fully empowers citizens to be involved in local decisions that are intended to benefit their community. The current citizen participation regulations in our opinion do not go far enough to accomplish this goal, nor do they fully meet the missions of the HUD 2020 Management Reform Plan. The two missions of the Reform Plan are to:

- empower people and communities to improve themselves and to succeed in today's time of transition, and
- restore the public trust by achieving and demonstrating competence.

The basic elements of the Section 108 citizen participation regulations at 24 CFR 570.704 provide for informing citizens and requesting their comments on the proposed activities, through disclosure of specific information and records, meetings, and hearings; obtaining the views of citizens on community development and housing needs; and providing technical assistance if requested to groups representing low and moderate income persons in developing proposals. In our opinion, these regulations may not constitute what the public perceives as empowering people and communities. This is because the regulations do not go far enough to encourage grantees to involve citizens in the process of selecting the activities to be undertaken with Section 108 assistance, nor do they require full disclosure of details of the activities that citizens need to make decisions. For example, the regulations do not require disclosure of information about all aspects of the entire project that may be needed to make the Section 108 project feasible and to meet a national objective.

Our review of the Seattle and Spokane complaints indicated that there may be a need to enhance citizen participation. The complaints allege that there was insufficient citizen participation, that important information was not disclosed, and that citizens were not given the opportunity to decide on other possible alternatives for using the Section 108 program.

Even though Seattle and Spokane substantially met HUD's criteria for citizen participation, the citizens and firms representing citizen groups or companies that had concerns about or opposed the projects stated that they were not adequately informed or involved and not provided with pertinent information.

The Washington State Auditor also determined that the City of Spokane's reluctance to release records fostered public distrust in the City's involvement in the project. This conclusion was in a July 14, 1998 letter to the City about the State Auditor's review of concerns about the project.

In our opinion, when citizens perceive that they are not adequately involved, or when pertinent information is not disclosed, citizens may not trust the City's actions and may oppose the project. Increased citizen involvement in deciding how Section 108 assistance is used to meet a given objective may result in selecting projects more in accordance with the wishes of the citizens, and helps ensure that the positive public benefit outweighs the negative corporate welfare perception.

CPD comments

CPD stated that they believe the underlying citizen participation requirements do reflect the principles of the HUD 2020 Management Reform Plan to empower people and communities. CPD also stated that the Section 108 program is not in competition locally for grant funds, and the fact that citizens in two communities believed they were not adequately informed or involved is not sufficient to draw conclusions for the program as a whole. Regarding the statement in the draft report that citizens complained that they were not given the opportunity to decide on other possible alternatives for using the Section 108 program, CPD stated that by law, the authority to make decisions on funding choices is reserved to the unit of local government.

OIG evaluation of CPD's comments

CPD stated that it believes the current citizen participation regulations do reflect the underlying principles of the HUD 2020 Reform Plan, and that two cases are insufficient to draw conclusions on the whole program. However, we noted that CPD's recent actions indicate that HUD wants increased citizen participation in Community Development Block Grant programs. The HUD Business and Operating Plan is the vehicle for coordinating HUD's efforts to achieve its missions, strategic objectives, and annual performance goals. The HUD 2020 Program Services and Operations Manual (Manual) serves as a reference for HUD offices to carry out the Business and Operating Plan. The CPD section of the Manual lists five principles that seek to empower local citizens and communities, restore people's faith in government, and make government more responsive, more flexible, and more accountable to local citizens. One of the five principles is that: "Access to and communication with government at all levels and the people it serves must be increased." HUD's discussion of this principle in its Fiscal Year 1999 Annual Performance Plan states that: "Government must learn how to talk with local communities; it must reach out and involve local residents."

The Manual also shows that CPD recognizes the need to increase citizen involvement in presenting CDBG projects to be funded. The Manual states that the 2020 Planning and Mapping software empowers citizens and communities to among other things, present their own projects to local officials and citizens. Also, the section in the Manual on Empowerment Zones and Enterprise Communities (EZ/EC) also addresses resident empowerment and involvement in resource allocation. This section states that one of the main tenets of the EZ/EC Initiative is to empower residents and communities in their efforts to revitalize their distressed communities, and that residents are empowered by having a say in resource allocation decisions via representation on EZ/EC governance boards. In our opinion, the Section 108 program should also emphasize the empowerment of citizens, including having citizens help decide how Section 108 assistance should be used.

CPD commented that the unit of local government has the authority to make funding decisions. However, we believe that if citizens are to be empowered as envisioned in HUD 2020, local governments need to involve citizens in the decision making process, including which projects should be funded. Citizens want more control over decisions that affect them, according to a book co-authored by a consultant to HUD who reviewed HUD's implementation of the HUD 2020 Reform Plan. The book, *Reinventing Government*¹, includes the statement in the chapter on Community-

¹ David Osborne and Ted Gaebler, *Reinventing Government How the Entrepreneurial Spirit is Transforming the Public Sector*, (Published by the Penguin Group, Printed 1993) p. 74

Owned Government: Empowering Rather Than Serving, that “What Americans *do* hunger for is more control over matters that directly affect their lives: public safety, their children’s schools, the developers who want to change their neighborhoods.” Having more control over the developers that want to change their neighborhoods may apply to the Spokane Section 108 project. One of the complaints about the project was that citizens did not have input into how the Section 108 program could best be used to revitalize downtown.

We agree with the principles in the HUD 2020 Program Services and Operations Manual that seek to improve citizen participation. We believe that if implemented, these principles will help to increase citizen involvement in Section 108 projects and thereby help CPD to further its mission to empower people and communities. One of the actions that would help bring this about would be for CPD to encourage grantees to give citizens a larger role in the decision making process for Section 108 assistance.

Displacement of businesses and jobs

HUD regulations implementing a statutory requirement that grantees minimize the displacement of businesses and jobs do not require grantees to perform an analysis or to document the actions they take to comply with the requirement. Consequently, HUD has limited assurance that grantees are complying with the statutory requirement.

HUD regulations at 24 CFR 570.203(b) apply to assistance to for-profit businesses under CDBG programs, including Section 108. The regulations require that in selecting businesses to assist, the grantee shall minimize to the extent practicable, the displacement of existing businesses and jobs in neighborhoods. However, with no requirement for analyzing or documenting compliance, HUD has little assurance that grantees are complying with this statutory requirement.

The preamble to the January 5, 1995 final rule that implemented the regulations, 60 FR 1924, stated that several of the six commentors that addressed this issue recommended that further guidance be provided for this requirement. However, HUD determined that it was most appropriate to leave the final rule provisions as proposed on this issue so that grantees will have flexibility in demonstrating compliance with the requirement as appropriate under the circumstances.

Prior to issuance of the final rule, HUD guidance regarding documentation of the anti-displacement requirement was provided in a March 6, 1992 memorandum from the Assistant Secretary for CPD, Anna Kondratas. The memorandum stated:

“I expect that each grantee will evaluate the potential of each proposed economic development project for causing displacement of existing businesses and lost jobs in the neighborhood where the project is proposed to be located. When the grantee concludes that the potential exists to cause displacement, given the size, scope or nature of the business, then the grantee, must to the extent practicable, take steps to minimize such displacement. The project file must document the grantee’s review conclusions and if applicable, steps taken to minimize displacement.”

This memorandum shows that HUD expected grantees to document their conclusions and actions for the anti-displacement requirement. However, the memorandum was superseded by the regulations which do not require evaluating or documenting compliance with the requirement.

The effect of not having a regulatory requirement for analyzing or documenting compliance may be that grantees do not make an analysis and therefore do not know what displacement may or will occur and consequently what assistance may be needed to comply with relocation regulations. For example, the City of Spokane did not make a displacement analysis until we raised the issue, which was after HUD approved the application. By that time several businesses had been displaced from the area that was to be demolished for the new mall.

In our opinion, giving grantees flexibility by not requiring a documented analysis and/or certification of compliance at a specific time in the process may result in grantees not putting in place management controls to ensure compliance with the statutory requirement.

CPD comments

CPD stated that the documentation requirements in 24 CFR 570.506 are sufficient to address this concern.

OIG evaluation of CPD's comments

The anti-displacement regulation does not specify that an analysis, a determination, or a certification is required, only that in selecting businesses to assist, the recipient shall minimize displacement to the extent practicable. In our opinion, at the least it is not clear how the record keeping requirements in 24 CFR 570.506 apply. The flexibility given to grantees by regulations that do not require an analysis or documentation may preclude measuring their performance or holding them accountable. We believe that HUD should determine if grantees are complying with the requirement, as part of HUD's grantee monitoring process. Also, the contractor on the CPD Economic Development Loan Study could obtain information about this issue, by obtaining from grantees information on the methodology they used to comply with this requirement and the results they obtained. HUD could then evaluate the results and determine if changes were needed to the program rules.

Presumption alternative for meeting a national objective

HUD regulations allow for a presumption that a Section 108 project will meet a national objective based on job creation for primarily low and moderate income persons, even though there may be evidence that the jobs may not be taken by low and moderate income persons.

HUD regulations at 24 CFR 570.208(a)(4)(iv) which apply to the CDBG program including Section 108 provide for meeting the national objective of creating or retaining jobs for low and moderate income persons on the basis of a presumption. The presumption is that if an employee resides in, or the assisted activity and the jobs are located in a census tract that meets certain percentages of poverty, the employee shall be presumed to be a person of low or moderate income. This provision is statutory, in section 105(c)(4) of the Housing and Community Development Act of 1974, as amended.

The Spokane Section 108 project used the presumption alternative to qualify the project as meeting a national objective. The project was located in a census tract that met the percentage of poverty requirements to qualify under the presumption alternative. However, complainants questioned how it could meet a national objective when there was evidence that a substantial percentage of the residents of the census tracts were elderly retired persons, who would not be expected to take the jobs.

According to the preamble to the January 5, 1995 final rule at 60 FR 1933, and a letter from HUD Headquarters to a grantee, the “evidence to the contrary” provision in the regulations for national objectives at 24 CFR 570.208(a) does not apply to the presumption provision, and such evidence cannot be used to challenge compliance with the national objective. In our opinion, this takes away any assurance that a national objective will be met.

We believe that the presumption alternative should be rebuttable. We believe that the “evidence to the contrary” rule is sound since it ensures that a national objective is met, and that it should apply to the presumption alternative.

CPD comments

CPD stated that HUD’s General Counsel confirmed that the statutory requirement for the presumption alternative cannot be overridden by the program’s regulatory language regarding “evidence to the contrary”.

OIG evaluation of CPD’s comments

We agree that General Counsel confirmed that the presumption alternative cannot be overridden. However, our point was that grantees could use the presumption alternative for projects that may not otherwise meet a national objective. The presumption may give citizens the impression that HUD’s rules provide loopholes for getting around the national objective requirement.

If citizens can present evidence that a project will not meet a national objective because, for example, the jobs created will not go to low and moderate income persons, then it would seem prudent (and would further the HUD 2020 Plan’s mission to restore the public trust) to question the grantee’s choice of such a project for Section 108 assistance.

The CPD Loan Study could provide information as to whether or not the presumption alternative has had an adverse effect on Section 108 projects meeting a national objective. The contractor on the study could determine if using the presumption alternative has been a problem at the grantees in the study sample who used the presumption alternative, if any. If the study shows that it has been a problem, then HUD should consider introducing legislation to change the law to allow the “evidence to the contrary” rule to remain in effect for the presumption alternative.

Timeliness of HUD approval of Section 108 loan guarantee

There has been a long delay in obtaining HUD approval for the Spokane Section 108 loan guarantee. HUD Headquarters took from June 1996, when it received the Seattle HUD office's letter to proceed with processing, until June 1997 to approve the commitment for the loan guarantee. HUD approved the commitment for the loan guarantee on the condition that various conditions be met before HUD approved the loan guarantee. According to a HUD Headquarters official, HUD approved the loan guarantee on January 13, 1999.

The delays may have contributed to problems with the City's compliance with relocation and environmental review requirements. The City took the position that it would not notify displaced businesses that they may be eligible for relocation assistance until HUD approved the loan guarantee. The City approved permits and the developer completed demolition and started redevelopment even though HUD had not approved the release of funds.

HUD should consider if excessive delays have occurred with other Section 108 applications, and if so it should analyze the reasons for the delays and take whatever action is necessary to avoid such delays in the future.

CPD comments

CPD stated that HUD has a public trust responsibility to carefully review applications and ensure that requirements are met and that there is sufficient security to support repayment. CPD stated that the Spokane 108 project was atypical with respect to controversy, size, and complexity, and that no valid inferences can be drawn from the Spokane project as to the length of time required for guarantees on other projects.

OIG evaluation of CPD's comments

We agree that HUD has a public trust responsibility to carefully review applications and ensure that there is sufficient security. Also, the time needed to approve the Spokane loan guarantee may have been atypical, but CPD did not provide support for this assertion. We believe that excessive delays can cause problems for the grantee. For example, after our field work was completed, the City of Spokane committed Section 108 funds to the Section 108 project, but HUD had not yet approved the Request for Release of Funds. Committing funds before HUD approves the Request for Release of Funds violates HUD regulations at 24 CFR 58.22(a). According to correspondence between the Office of General Counsel and CPD, HUD could determine for good cause to waive the regulations and proceed to approve the City's Request for Release of Funds. In our opinion, waiving the regulations was the only practical solution to the problem.

In our opinion, CPD should consider determining if other grantees have had problems because of excessive delays in approving the loan guarantee. CPD could obtain information about grantees' perception of HUD's approval process from the contractor on the CPD Loan Study. The contractor could determine, for the grantees in the study sample, if there is a perception by Section 108 recipients that the approval time is excessive, whether or not excessive delays have caused problems, and what the recipients believe has been the cause of the delays. HUD could then determine if action is needed to reduce the time needed to approve the application and the loan guarantee.

Assistance to grantees on environmental requirements

Grantees may need to be informed about how to obtain assistance in carrying out their environmental review responsibilities. The HUD environmental regulations at 24 CFR 58.4(a) which apply to CDBG programs including Section 108 require that grantees assume the responsibility for environmental review, decision making, and action that would otherwise apply to HUD under the National Environmental Policy Act (NEPA). Grantees must comply with the HUD environmental regulations as well as Council of Environmental Quality regulations at 40 CFR 1500 to 1508.

City of Spokane officials stated in their response to our draft report that they had difficulty obtaining assistance and guidance on environmental issues, as follows:

“The HUD regulations are vague and they provide absolutely no guidance on how a city is supposed to deal with comments. Nor does there appear to be an environmental office in place that has the expertise or capacity to assist the City in environmental review. Essentially, the City is left to flounder on its own using its best judgment under the circumstances. . . . From the City's perspective NEPA issues and compliance could be better addressed and resolved if a federal environmental specialist was involved from the beginning of the loan application.”

HUD should consider if other Section 108 applicants have had difficulty obtaining assistance in carrying out their environmental review responsibility. If other grantees have had difficulty, HUD should consider taking steps to ensure that grantees have access to assistance on environmental issues. This could include providing training and/or informing grantees about sources of information and expertise, including names of HUD or other agency officials, who are knowledgeable about different aspects of environmental reviews.

CPD Comments

CPD stated that the environmental requirements are clearly laid out, and that HUD staff are well aware of and properly trained on basic environmental requirements. CPD stated that Spokane's quote about its problems is probably an overstatement not representative of services provided by HUD to most grantees.

OIG evaluation of CPD's comments

We agree that Spokane's experience may not be representative. The contractor on the CPD Loan Study could determine if other grantees have had problems in carrying out their environmental

review responsibilities. Once this information is obtained, HUD could determine what if any action is needed.

Excessive profits to for-profit businesses

Section 108 loan guarantees for loans to for-profit businesses have the potential to create excessive profits. Excessive profits can result in the program not efficiently meeting its intended objectives, and may cause citizens to oppose the project even though it meets a public purpose. Citizen concerns and changes to the regulations several years ago, which deleted the requirement that grantees make an analysis to ensure that the assistance provided to a business is not excessive, indicate that it may be appropriate for HUD to review this issue to determine if changes are needed to control profits.

In 1992, Congress made statutory changes to the Community Development Block Grant program to enhance the ability of grantees to use those funds for economic development activities. A Congressional Committee had determined that HUD's rules for funding economic development projects were too burdensome and discouraged grantees from using CDBG funds for economic development. The Committee stated that HUD should focus on whether the amount of assistance was appropriate relative to the amount of public benefit to be derived, rather than on whether the assistance was necessary for the project to go forward.

Subsequently, HUD made regulatory changes which were intended to ease the grantees' burden associated with economic development activities. Specifically, in the final rule published on January 5, 1995, the words "necessary or" were deleted from the requirement that the assistance be necessary or appropriate to carry out an economic development project. The final rule also deleted from the regulations the requirement that grantees conduct an analysis to determine that the amount of any financial assistance to be provided is not excessive taking into account the actual needs of the business and the expected public benefit.

Current regulations for assistance to for-profit businesses require that the assistance be "appropriate" to carry out an economic development project (24 CFR 570.203(b)). Also, the regulations at 24 CFR 570.209 provide mandatory standards for public benefit, based on specific dollar limits of assistance per job or per person assisted. The regulations at 24 CFR 570.209 also provide underwriting guidelines. These guidelines include objectives for ensuring that project costs are reasonable and that to the extent practicable, the return on owner's investment will not be unreasonably high, but these guidelines are non-mandatory.

Our review of complaints on the Seattle and Spokane 108 projects showed that citizens were concerned about excessive profits and unnecessary assistance to corporations. Citizen complaints on the Spokane Section 108 project raised questions about the project benefiting the developer, and why public money was being used to support a private development. One citizen stated that the granting of federal money to this project would create a major imbalance and inequity as pertains to private investors risking their own capital. Complaints and media articles on the Seattle Section 108 project also raised questions about the developer receiving excess profits and the developer making payments to the retailer to help in renovating the Frederick and Nelson building.

Even though we only reviewed two Section 108 projects, we believe that the concerns raised by citizens and by the media, and the deletion of requirements to ensure that the amount of assistance

is not excessive, indicate that it would be prudent for HUD to reconsider this issue to determine if regulatory changes are needed. While the current regulations provide some control on the amount of the assistance through the public benefit standards, we believe HUD should review the regulations and its experience with the Section 108 program to determine if:

- controls are needed to limit the profit to businesses receiving Section 108 assistance, and
- HUD should encourage grantees to take other steps to control profit to businesses, for example, by incorporating competition into the process for selecting projects for Section 108 assistance.

The complaints on the Seattle and Spokane Section 108 projects also raised the issue of corporate welfare. Additionally we noted articles in Forbes magazine (April 20, 1998 issue) and Time magazine (four part series beginning with the November 9, 1998 issue) which discussed the issue of corporate welfare, and both articles raised questions about the Section 108 program. These and earlier articles on corporate welfare, including articles by the Cato Institute², point out some of the adverse effects of providing subsidies or benefits to specific firms or industries. The articles raised such pertinent issues as the appropriateness of the use of public money to build shopping malls, the unfairness of not having a level playing field for all businesses, and the fact that the jobs created by the assisted project are offset by losses of jobs elsewhere. In our opinion, citizens are less likely to consider assistance to for-profit businesses as corporate welfare if profits are not excessive, if they understand the program, and if there is citizen participation in the decision making process.

In our Seattle report, we recommended that HUD remind grantees that when their applications for the Section 108 program call for providing assistance to for-profit businesses, grantees need to explain to citizens how they met the regulatory requirement that the assistance be appropriate. We also recommended that HUD should determine if there was a need to address the public's and media's concerns and misconceptions about the Section 108 program, which included the corporate welfare issue.

CPD comments

CPD stated that our report did not make an adequate case for a review of excessive profits and corporate welfare, did not include factual evidence of excessive profits, and did not provide a substantive analysis of corporate welfare. CPD stated that economic development supported by Section 108 or CDBG must be viewed in the context of assisting a for-profit entity in return for a public benefit. The activity must meet a national objective, normally benefit to low and moderate income persons or elimination of slums and blight. CPD stated that the Seattle and Spokane 108 projects will create many jobs, and eliminate slums and blight or revitalize downtown. Assisting in the revitalization of inner cities is one of HUD's major goals. CPD said that in 1992 Congress settled the issue of requiring detailed analyses to determine how much assistance is enough, by requiring that HUD look at the public benefit. Section 108 loans must be repaid with interest at the Section 108 rate, and the loans are well secured.

² Stephen Moore and Dean Stansel, *Ending Corporate Welfare as We Know It*, Cato Institute Policy Analysis No. 225, May 12, 1995, and *How Corporate Welfare Won: Clinton and Congress Retreat from Cutting Business Subsidies*, Cato Institute Policy Analysis No. 254, May 15, 1996

OIG evaluation of CPD's comments

We agree that we did not obtain evidence that the assistance provided to for-profit businesses in Seattle or Spokane resulted in excess profits. We also agree that economic development activities under the Section 108 program, like other CDBG activities, must meet a national objective, and that Congress has determined that HUD should look to the public benefit, not to how much assistance is enough. CPD's comment that assistance under the program is in the form of loans that must be repaid is important since the program does not involve the type of "corporate welfare" as programs that involve direct taxpayer assistance to businesses (although as in Spokane, a project receiving Section 108 assistance may also receive an Economic Development Initiative grant and/or local government subsidies or benefits).

However, citizens in the two cities we reviewed were concerned about excess profits. Providing Section 108 assistance to selected businesses raises questions about fairness and about the actual public benefit. HUD will obtain information on the public benefit for a sample of CDBG economic development activities, since the CPD Economic Development Loan Study will determine public benefit for the study sample. One of the objectives in the Statement of Work for the study is to assess the basic performance of CPD economic development loans in terms of overall and low-moderate-income job creation. The contractor could also obtain information on grantees' awareness of and perceptions about profits, and whether they believe that controls on profits are needed. With this information, HUD will be in a better position to evaluate if changes are needed to address the excess profits issue.

Disclosure of information by applicants

Grantees may not be disclosing sufficient information in their Section 108 applications, including information required to be disclosed under the HUD Reform Act, so that citizens have the information they need to make informed decisions. In our opinion, citizens need information and records not only about the project funded by Section 108 funds, but also about the other related projects that are needed to make the Section 108 project feasible and that are needed to meet a national objective.

The HUD Reform Act of 1989 requires that applicants for HUD assistance (including the Section 108 program) disclose three items with respect to any application for HUD assistance (24 CFR 4.9):

- other government assistance,
- the names and interests of persons having a financial interest in the project, and
- the sources and uses of funds that are available for the project.

Complaints on the Seattle and Spokane Section 108 projects disclosed that citizens and firms representing citizen groups or companies, believed that important information was not disclosed. We also determined that both Seattle and Spokane did not include in their applications the information required to be disclosed under the HUD Reform Act. The information required under the HUD Reform Act may have addressed some of the complainant's concerns on the Spokane project, but the complainants also sought information that the City claimed was proprietary business information or was exempt from disclosure by attorney-client privilege.

Seattle and Spokane City officials involved in preparing the applications stated that they were not aware of the disclosures required under the HUD Reform Act requirement. This is in spite of the fact that the HUD Reform Act disclosure requirements became effective on January 16, 1992, and the Notice of the effective date of the regulations, in 57 FR 1942, dated January 16, 1992, stated in Section 6.a.ii:

For applicant (initial) disclosures, the Department wishes to make clear its firm intent in no case to commit covered assistance to the applicant, unless all subpart C's disclosures have been provided.

We noted that the HUD Reform Act disclosure regulations are separate from and are not referred to in the CDBG regulations at 24 CFR 570, and this may contribute to grantee's lack of awareness of the requirement.

In our opinion, citizens need information about the full extent of the project, including how a national objective will be met and how the project is feasible, as well as the information required to be disclosed under the HUD Reform Act. The HUD Reform Act requirements were enacted to ensure greater accountability and integrity in the way in which the Department makes assistance available.

This information can help citizens make informed decisions about the risks and obligations that they are being asked to undertake, and whether or not to support the project. In our opinion, requiring this information will also help the Department meet the mission of the HUD 2020 Management Reform Plan to restore the public trust.

CPD comments

This issue was included in the Seattle Section 108 report. CPD did not provide additional comments on this issue for this report. In the Seattle report, we recommended that HUD remind grantees of the importance of full disclosure of information about the entire project including how the project met the spot blight national objective, if applicable. The Seattle report also included a recommendation that HUD instruct CPD offices and grantees regarding the need to comply with HUD Reform Act disclosure requirements, and to take steps to ensure that the requirements are enforced. We are not making any additional recommendations.

Citizen concerns and misconceptions about the Section 108 program

Citizens and the media have concerns and misconceptions about the Section 108 program which may effect their decisions about supporting or not supporting Section 108 projects. The citizen complaints and news articles we reviewed for both Seattle and Spokane included statements that the program:

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

In our opinion, these types of concerns and misconceptions, if not addressed by HUD, may damage the integrity of HUD and of the Section 108 program. These concerns and misconceptions may also prevent citizens from supporting Section 108 projects that they would support if they understood the program.

CPD comments

This issue was included in the Seattle Section 108 report, and CPD did not provide additional comments for this report. We recommended in the Seattle report that HUD 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. In our opinion, HUD should consider issuing policy statements or submitting letters to the editor when HUD programs or activities receive negative publicity, in order to bring balance to the information available to the public.

Guidance on how an activity can qualify under the spot blight national objective

HUD should decide if it needs to better define the conditions needed for a project to meet the spot blight national objective. HUD regulations on criteria for national objectives, at 24 CFR 570.208, do not provide regulatory standards for identifying spot blight. HUD officials stated that because of the wide variety of conditions that exist, there needs to be room for a broad interpretation.

The complaints on the Seattle Section 108 project included allegations that the City manufactured its own definition of spot blight. The complaints cited a letter written by a City official which stated

that spot blight is whatever the City says it is. In our opinion, lack of guidance as to the conditions that constitute spot blight may give the public the perception that spot blight can be used when no other objective is applicable. Defining the minimum conditions that projects must meet to qualify under the spot blight national objective may help HUD to meet the mission in the HUD 2020 Reform Plan of restoring the public trust.

CPD comments

This issue was included in the Seattle Section 108 report, and CPD did not provide additional comments for this report. The Seattle report included a recommendation that HUD 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 national objective.

Conclusion

We believe the opportunities for improving the Section 108 program that we identified could help to achieve the missions of the HUD 2020 Management Reform Plan to empower people and communities and to restore the public trust in the Department and its programs.

The opportunities for improvement discussed in this report may be of interest to the HUD Office of Policy Development and Research (P D and R), and to the contractor that P D and R selects to perform the CPD Economic Development Loan Study. We noted that the Statement of Work for the Study, in Part A, Research Objectives, included determining how changes in program rules have affected communities' use of third party loans. In determining the effect of rule changes, the contractor could inquire about the effect of the following changes to the regulations:

- adding the requirement to minimize displacement,
- adding the provision allowing the use of the presumption alternative for meeting a national objective, and
- deleting the requirement to make an “unduly enrich” analysis in conjunction with loans to for-profit businesses.

As discussed in the Results and the Recommendations section of this report, the contractor could also obtain additional information from the grantees in the study sample about some of the issues we raise in the report.

Recommendations

The recommendations in this report do not include the recommendations that were included in the report on the Seattle Section 108 project. Those recommendations will be resolved in accordance with HUD Handbook 2000.6 REV-2. This report includes recommendations for the opportunities for improvement that were not addressed in the Seattle report.

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

- 1A. Provide this memorandum report to the Office of Policy Development and Research, and to the contractor selected to perform the CPD Economic Development Loan Study, along with suggestions for incorporating the issues in this report in the Study.
- 1B. Consider informing grantees of the need to encourage citizens to have a larger role in the decision making process for Section 108 assistance.
- 1C. Require the contractor for the CPD Economic Development Loan Study to obtain, for the grantees in the study sample, information on the methodology they used and the results they obtained to comply with the anti-displacement requirement, evaluate the results, and make changes to the program rules as necessary.
- 1D. Require the contractor for the CPD Economic Development Loan Study to determine for the study sample whether or not the grantees' Section 108 activities used the presumption alternative, and whether or not this resulted in an adverse effect. If necessary, consider introducing legislation to change the law to allow the evidence to the contrary rule to remain in effect for the presumption alternative.
- 1E. Require the contractor on the CPD Economic Development Loan Study to determine for the study sample if grantees that obtained Section 108 assistance perceive that the loan guarantee approval process took too long, and once this information is available, make changes as necessary.
- 1F. Require the contractor on the CPD Economic Development Loan Study to determine for the study sample if grantees had problems getting assistance or expertise for carrying out their environmental review responsibilities, and once this information is available, make changes as necessary.
- 1G. Obtain and evaluate the information from the contractor on the CPD Economic Development Loan Study, on the public benefit actually realized for Section 108 activities in the study sample. Also, require the contractor to obtain information about grantees' awareness of and perceptions about profits, and make changes to program rules, if needed, to control the profits to for-profit businesses under the Section 108 program.

Office of Community Planning and Development's comments



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

OFFICE OF THE ASSISTANT SECRETARY FOR
COMMUNITY PLANNING AND DEVELOPMENT

JAN 14 1999

MEMORANDUM FOR: Robert H. Woodard, District Inspector
General for Audit, Northwest/Alaska, OAGA

FROM: *John M. Semura*
Kenneth C. Williams, Deputy Assistant Secretary for
Grant Programs, DG

SUBJECT: Comments on Draft Inspector General Audit of
Section 108 Loan Guarantee Program
Opportunities for Improvement Identified
during Review of Complaints on Section 108
Projects in Seattle and Spokane, WA

This responds to your memorandum dated November 6, 1998, to CPD's Assistant Secretary and the Director of the Office of Block Grant Assistance seeking comments on a draft memorandum report on opportunities for improvement to the Section 108 Loan Guarantee program. The issues presented in the draft memorandum report stem from the IG's review of citizens' complaints generated by two 108 projects in Seattle and Spokane, Washington. Your memorandum requests that we (1) provide suggested recommendations for corrective action; (2) advise whether we concur or nonconcur with the audit results; and (3) provide any facts not previously known to the auditor which might influence the manner in which matters will be reported.

Before responding specifically to the issues you raise, it is important to provide an overall description of the strengths of the Section 108 loan guarantee program. This program provides cities an opportunity to leverage their CDBG program grant dollars and take on additional activities for which they would otherwise not have the resources. Economic Development has become the principal use of this program which has been greatly expanded over the past 6 years. Communities have chosen to use this tool as part of the comprehensive planning and execution process, which by its nature, often involves competing priorities. Cities commit other local and state resources as well as leverage private funds. Normally many jobs are involved as is the case in Seattle and Spokane. Cities must make priority choices within the Comprehensive Planning process to identify priority needs and choose activities to address those needs. HUD selection or endorsement of one project

over another is not required. These are local choices as is the case with CDBG. HUD's role is to ensure that program requirements as proscribed in regulation are met, particularly national objectives. It is within this context that we respond to your suggested issues.

Please note that the final memorandum report should be addressed to Cardell Cooper, CPD's Assistant Secretary, instead of Saul Ramirez, Jr. Our recommendations and comments follow each of the issues listed on pp. 11 and 12 of your memorandum.

1. *Providing this memorandum to the Office of Policy Development and Research, and to the contractor to perform the CPD Economic Development Loan Study, for their information.*

This report will be furnished to the Office of Policy Development and Research and the contractor.

2. *The adequacy of citizen participation regulations for the Section 108 program in view of HUD's missions stated in the HUD 2020 Management Reform Plan.*

The audit cites the Section 108 regulations as inadequate with respect to citizen participation. A suggestion is made that the Section 108 citizen participation requirements should be revised to conform to the HUD 2020 Management Reform Plan. It is not clear exactly what is meant by "conform to the HUD 2020 Management Reform Plan." We believe that the underlying citizen participation requirements do reflect the principals of the HUD 2020 Management Reform plan to empower people and communities.

Communities are required to have and follow a written citizen participation plan, which itself is subject to public input. The fundamentals of that plan require the community to:

- Make a proposed application available for comment in sufficient detail to allow citizens to know how they might be affected.
- Hold a minimum of 2 public hearings, each at a different stage of the program
- Consider public comment and make changes the community believes are warranted.

Regarding the auditor's comment that the regulations governing citizen participation requirements in this program "do not constitute empowering people and communities," we disagree. It should also be understood that the Section 108 program is not in competition locally for grant funds. This program provides additional resources to the community. The fact that citizens (which, in the interest of full disclosure, include political opponents of officials supporting the project and in the case of Spokane a major competitor of the developer) in two communities believed that they were not adequately informed and involved is not sufficient to draw conclusions for the program as a whole. Furthermore, the audit report states that the complaints allege that "citizens were not given the opportunity to decide on other possible alternatives for using the Section 108 program. By law, the authority to make decisions on funding choices is reserved to the unit of general local government. We believe that the citizen participation requirements are sufficiently empowering.

3. *Applicants' compliance with the statutory requirements to make efforts to obtain financing for the Section 108 project without the loan guarantee, in those states that have laws prohibiting the lending of credit.*

This issue must be addressed in the larger context of efforts that have been taken by Seattle and Spokane. Apparently Washington State law does prohibit a city from loaning state or local funds to for profit entities. The loan guarantee under Section 108 is not so effected. Nevertheless, both cities and private entities made significant efforts in other ways to support the projects they believed would provide substantial public benefit. The following is a summary of that effort:

**Seattle
Frederick & Nelson Project**

Sources:	
Section 108 debt*	\$ 23,451,573
Private debt	\$ 85,994,800
Equity	\$ 7,000,000
Total	\$ 116,446,373

Uses:	
Acquisition	\$ 26,500,000
Closing costs	\$ 500,000
Redevelopment costs	\$ 45,251,200
Tenant improvement	\$ 34,246,630
Interest and financing	\$ 9,948,543
Total	\$ 116,446,373

* Section 108 loan amount was \$24 million. Balance of \$748,427 reserved for capitalized interest and contingency.

**Spokane
River Park Square**

Sources:	
Garage Sale/Leasehold Value	\$ 5,092,934
Equity - Land	\$ 3,263,374
Equity - Cash	\$ 15,000,000
Interim Revenue	\$ 5,399,564
Section 108 loan	\$ 22,650,000
Private debt	\$ 19,848,578
HUD EDI grant	\$ 1,000,000
Total	\$ 72,254,450
Uses:	
Project costs	\$ 66,786,019
Debt reserve	\$ 1,000,000
Construction interest	\$ 4,468,431
Total	\$ 72,254,450

This issue of financing was raised in connection with your review of the Spokane project. We recommended that the Spokane City Attorney issue an opinion on the City's position that the only mechanism available under State law for making a loan to the developer is the use of Section 108. The City Attorney has issued an opinion supporting that position. The Office of General Counsel has since reviewed elements of the Spokane guarantee and raised no objections.

The law does not require that a city use its own funds for a Section 108 project.

4. *The lack of a requirement for grantees to analyze and document or to certify compliance with the requirement to minimize, to the extent practicable, the displacement of businesses and jobs.*

The audit argues that, without a requirement to perform an analysis or document actions taken to comply with the requirement of 570.203(b) to minimize the displacement of businesses and jobs in neighborhoods, grantees may fail to comply with the regulation.

The current requirements on documentation at 24 CFR 570.506 are sufficient to address this concern.

5. *The lack of applicability of the "evidence to the contrary" rule for the presumption alternative for meeting a national objective for job creation and retention activities.*

The report indicates that the presumption under 570.208(a)(4)(iv) permitting jobs to be presumed to be held by or made available to low/mod persons based upon residence or business location may result in a failure to meet a national objective. The report also states that the regulatory language at 24 CFR 570.208(a) should be applied to this presumption. This section of the regulation states that activities meeting the applicable regulatory criteria are presumed to benefit low- and moderate-income persons unless there is "substantial evidence to the contrary."

We do not agree with that recommendation. Our General Counsel has confirmed that this statutory presumption cannot be overridden by the program's regulatory language at 24 CFR 570.208(a). Our position on this is stated on page 8 of the Spokane audit (1998-SE-148-0001, dated September 30, 1998). In response to this same issue which had been raised by one of HUD's field offices in 1997, a memorandum dated September 5, 1997, from Richard Kennedy was sent to the CPD Director in the Georgia State Office. It clearly states that the presumption for which the auditor expresses concern was specifically authorized by Congress when it passed the Housing and Community Development Act of 1992, amending section 105(c)(4) of the Housing and Community Development Act of 1974.

6. *The delay in approving the Spokane Section 108 loan guarantee, and delays in approving other Section 108 loan guarantees, if applicable.*

HUD has a public trust responsibility to carefully review 108 applications to ensure they meet all program requirements and has a fiduciary responsibility to ensure there is sufficient security to support repayment. Much of the time that has elapsed has been well used (by Spokane as well as HUD). The financial structure of the River Park Square project is extremely complicated. The City chose to engage financial advisors to evaluate the risk of the proposed loan from the City to the developer. Negotiations between HUD and the City were placed on hold until that review was completed. Ensuing negotiations between HUD and the City disclosed the need for additional security to be furnished beyond that originally proposed by the developer. The negotiations involved numerous iterations of draft documents until final agreement was reached. Ultimately, HUD was successful in obtaining additional collateral in the form of a corporate guaranty that protects both HUD's and the City's interests.

As a final matter, no valid inferences can be drawn from the Spokane project as to the length of time required for guarantees on other projects. The Spokane project is atypical with respect to controversy, size, and complexity.

7. *Assistance to grantees on environmental review requirements.*

The environmental requirements for CDBG and 108 are clearly laid out at 24 CFR Part 58. HUD staff and grantees are well aware of and properly trained on basic environmental requirements. It should be noted that the single quote in the report from the grantee is probably an overstatement concerning the lack of guidance Spokane received from HUD staff and is certainly not representative of services provided by HUD to most grantees.

8. *Excessive profits to businesses and the issue of corporate welfare.*

Your report recommends a nationwide review of excessive profits and corporate welfare (including the effect of the statutory prohibition against requiring an "unduly enrich" analysis). We do not believe your report makes an adequate case for such a review. The discussion of this subject in the report is conjectural and unsupported by any factual evidence of excessive profits. The use of the pejorative term "corporate welfare" in connection with Section 108 is inappropriate. Your discussion does not provide any substantive analysis of corporate welfare, other than to refer to magazine articles. (The use of this term by ideological opponents of a particular program or project may be effective in a polemical sense, but it is hardly enlightening.)

Economic development supported by Section 108 or CDBG funds must be viewed in the context of knowingly assisting a for-profit entity in a financial way in return for a public benefit. In Section 108 loan guarantees and in CDBG that means the activity must meet a program national objective, normally either benefit to low- and moderate- income persons or elimination or prevention of slum and blight. In both cases described in this audit, large numbers of jobs will be created. In Spokane an estimated 800 jobs will be created, the majority of which will be for low- and moderate- income persons. The majority of these jobs are presumed to be for low and moderate income persons because the location of the businesses will be in a high poverty area. In Seattle the national objective met was slums and blight, but there also, many jobs were retained in the city.

Further, in the case of Spokane, the City's choice to pursue this project will also have a huge affect in the revitalization of downtown Spokane. Assisting in the revitalization of inner cities is clearly one of HUD's major goals.

The other alternative of requiring detailed analysis by federal officials of widely varying financial deals to somehow compute how much assistance is enough was settled by Congress in 1992. The details of those actions were laid out in your previous Seattle and Spokane audits. The statutory provision provided that HUD should not deny funding based on such analysis but rather should look to public benefit.

The projects in Seattle and Spokane do not provide a sufficient basis to revisit the issue. Approximately \$47 million of the \$48 million approved for these projects consists of loans that must be repaid with interest at the Section 108 rate. These loans are well secured, in one case by a letter of credit from a rated bank and in the other case by a mortgage and corporate guaranties.

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