



**U.S. Department of Housing and Urban Development**  
New England Office of District Inspector General  
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Audit Related Memorandum  
No: 99-BO-119-0801

October 26, 1998

MEMORANDUM FOR: Charles Wehrwein, Deputy Assistant Secretary for Multifamily Housing, HM

FROM: William D. Hartnett, District Inspector General, Office of Audit, 1AGA

SUBJECT: Advisory Report on Section 8 Contract Administration

This report presents our review of six Contract Administrators in New England. We wanted to evaluate the performance of Contract Administrators and identify any issues that could have an effect on the Department's plan to contract out the administration of Section 8 Housing Assistance Payments. Contracting out project-based Section 8 administration is critical to the framework of the HUD 2020 Management Reform Plan. Proper implementation of this activity could have a positive affect on HUD's future.

At the September 10, 1998 meeting, you stated that you were planning to issue a performance-based contract. Under a performance-based contract, the Department would define objectives to be completed under the contract. You informed us that the Department does not have experience with performance-based contracting. We are presenting information about the operations of six Contract Administrators to assist the Department in its preparation of these objectives for its Request for Proposals. This will be HUD's first Request for Proposal for a performance-based contract. We have also identified a number of issues that the Department should consider while preparing this Request for Proposals. Recognizing and addressing these issues will assist the Department in successfully transferring the administration of Section 8 Housing Assistance Payment Contracts.

Since your office is developing the Request for Proposals, we believe that timely presentation of data from current Contract Administrators will be beneficial. Therefore, we are not presenting a draft report seeking comments. Also, we have not included any recommendations.

Please keep us advised of any changes in the preparation and issuance of the Request for Proposal. We look forward to continuing to work with you on this issue. We thank you and your staff for the courtesy shown to us during the audit. If you have any questions, please call me or Robert Lidak, Senior Auditor, at 617-565-5259.

## Executive Summary

As reported in OIG's March 31, 1998 Semiannual Report to Congress, HUD plans to contract for the administration of Project-Based Section 8 Housing Assistance Payments Contracts. HUD is currently undergoing extensive reorganization under its HUD 2020 Management Plan. The Plan involves major staff downsizing, modification of HUD's organizational framework, consolidation of programs and significant changes in the way HUD conducts its business. With these changes, HUD has sought new ways to conduct its business; such as the Request for Proposals for outside contractors to administer HUD's portfolio of Section 8 contracts.

Our objectives are to evaluate the performance of Contract Administrators in New England and pro-actively identify issues that could affect the Department's plan to contract out the administration of Section 8 Housing Assistance Payments contracts. Contracting for administration of Section 8 projects is a critical area helping to form the framework of HUD's 2020 Management Reform Plan.

On March 24, 1998 and April 10, 1998, the Inspector General issued memoranda commenting on the draft Request for Proposals (RFP). The Housing staff did not reply in writing to these memoranda but held several discussions with OIG staff. Since that time, Housing has revised the RFP several times. Also, HUD staff advised us that OMB had verbally raised issues concerning the RFP which, they indicated, they are addressing.

On September 10, 1998, Housing officials advised that they are currently redrafting the RFP. The redrafted RFP will result in a performance-based contract that would include incentives for exemplary performance and disincentives when required tasks are not completed. This will be HUD's first RFP for a performance-based contract.

We examined the operations at six Contract Administrators: three Housing Finance Agencies, two Public Housing Authorities and one State Agency. These Contract Administrators administer HAP contracts for 362 projects in New England. We did not find any significant problems at the three HFAs. The two Public Housing Authorities were not performing all of the functions required; but were receiving full fees. The Public Housing Authorities did not believe that they were responsible for all of the required functions. Initially, HUD staff were performing some of these functions for the insured projects. The State Agency was not monitoring timely nor following up on identified concerns. The State Agency attributed its difficulties to its recent staff cutbacks and reorganizations.

In addition to the concerns raised in the Inspector General's memoranda, we identified several issues that we believe need to be addressed in order to successfully transfer the Section 8 contract administration function.

1. **Cost-Benefit Analysis:** HUD needs viable cost benefit analysis. While cost is not the only factor driving the Department, a comparison of cost to benefits should be performed
2. **Interrelationships:** Successful transfer of the Section 8 contract administration function is dependent upon strong working relationships between the Real Estate Assessment Center, the Financial Management Center, the Enforcement Center, the Government Technical Monitors/Representatives and the Field Offices. These Centers represent a dramatic change in HUD operations. These Centers are just beginning to operate and their effect on the Department is, at this time, uncertain.
3. **Monitoring:** HUD needs to effectively monitor both project performance and contractor performance. Operations at HUD's new Centers will affect how HUD remotely monitors the performance of projects whose HAP contracts are being administered. It is unclear how Contract Administrators and these Centers will work together to resolve problems at projects. To resolve a problem, the coordination of information reported to the Contract Administrator, the Real Estate Assessment Center, the Financial Management Center, the Multifamily HUB and, in some cases, the Enforcement Center may be necessary.

HUD needs to develop procedures to deal with non-performing Contract Administrators including, potentially, the removal of a Contract Administrator. These procedures and the results of monitoring reviews of the Contract Administrators need to be communicated, not only to the Contract Administrators, but to all of the Centers and Hubs working with properties within the Contract Administrator's portfolio.

4. **Transfer of Responsibility:** HUD will need to identify the manner, timing and data to be transferred between HUD and the Contract Administrator at the inception and the completion of the contract. The transfer of responsibility needs to take into account the tasks to be performed, the data to be maintained in HUD computer systems, and HUD's ownership of data in written and electronic forms.
5. **Financial Interest in the Properties being managed:** HUD needs to be aware of any financial interest in the properties held by any Contract Administrator or held by any instrumentality of a Contract Administrator. HUD could use this data to evaluate potential conflicts of interest and the propriety of the relationships. HUD needs to establish parameters for Contract Administrators having financial interests in any projects.
6. **Staffing Plan:** HUD needs to have the Contract Administrators' proposed staffing plan and to use that staffing plan to evaluate the bid and monitor performance under the contract. While an entity may have sufficient staff at the inception of the contract, during the course of the contract, the entity may downsize or reorganize so that the remaining staff can no longer handle the workload.

7. **Expiration and Renewal of Section 8 contracts**: Expiring contract are subject to one-year renewals. One-year renewals represent a greater workload than five-year or twenty-year renewals. This workload should be factored into the evaluation of potential Contract Administrators. The workload could increase the amount of the bids on the RFP.
8. **Training Contract Administrators to detect and report Suspected Fraud**: HUD needs to ensure that the Contract Administrators obtain sufficient training to detect and report suspected fraud including underreported income, poor workmanship, and equity skimming.
9. **Legal issues arising from Enforcement of HUD regulations by the Contract Administrators**: HUD needs to develop procedures to address legal actions brought against the Contract Administrators acting on behalf of the Department to (1) protect the Contract Administrator when acting lawfully on behalf of the Department and (2) protect the Department from unauthorized or illegal acts performed by the Contract Administrator that are contrary to or beyond the scope of their contract.

On September 10, 1998, we met with the Housing staff in Headquarters. We provided the Housing staff with the results of our examinations at the six Contract Administrators and discussed the issues presented in this report.

## Background

As part of its HUD 2020 Management Reform Plan, HUD is putting together a Request for Proposals (RFP) for Contract Administrators for Project-based Section 8 Housing Assistance Payments (HAP) Contracts. HUD assists projects with over 24,000 HAP contracts across the country. The Section 8 HAP program is a rent subsidy program that assists eligible low-income families to obtain decent, safe, and sanitary housing. A rental subsidy, known as a HAP, is paid by HUD to a property owner on behalf of an eligible tenant family for a portion of the eligible family's rent.

HUD estimates that Public Housing Agencies administer approximately 4,200 HAP contracts at this time. HUD administers another 20,000 Section 8 HAP contracts. By law, administration of the Section 8 contracts may be transferred to entities that qualify as "Public Housing Agencies", as defined in statutes 42 U.S.C. 1437a(b)(6) and 1437f(b)[(1)]. HUD is authorized to enter into annual contributions contracts (ACCs) with such Public Housing Agencies for administration of Section 8 contracts.

The owners of these HUD-assisted projects are responsible for providing management and maintenance of the project in conformance with HUD regulations, the subsidy contract, and administrative requirements. The Contract Administrators are responsible for oversight management of the project owner and management agent by:

- assuring compliance with the terms of the HAP contract, HUD Regulatory Agreement, applicable HUD regulations, and other administrative requirements.
- assuring the project owners are providing decent, safe, and sanitary housing to the assisted tenants.
- taking the necessary steps to prevent the opportunity for fraud, waste, and mismanagement in the operation of the project.

Under the ACC and this RFP, Contract Administrators will perform the following tasks:

- Inspect units annually using a certified inspector and require the owner to correct deficiencies or abate Section 8 payments to an owner for units that are below standard.
- Administer occupancy and management tasks consistent with HUD Handbooks and other HUD requirements. This includes, but is not limited to: review and oversight of owner's management practices covering maintenance and security, financial management, occupancy, income verifications and tenant selection, and review of owner vouchers.

- Assure the accuracy of contract rents, assistance payments to owners, and utility allowances for tenant-paid utilities.
- Review all owner invoices, including special claims, to make Section 8 payments to the owner in accordance with the HAP contract for units which meet contract requirements.
- Maintain complete books and records on each HAP contract with submissions to HUD as provided in the RFP and the ACC.
- Assure owners' compliance with HUD's Annual Financial Statement protocol.
- Promote good community and tenant relations by encouraging resident initiatives, and supporting the formation and maintenance of resident councils.
- Cooperate with and support HUD HUBs/Centers
- Assist HUD field staff, management agents and owners to resolve outstanding issues.

## **Reasons why HUD wants to contract out this function**

The Department is undergoing extensive reorganization under its HUD 2020 Management Reform Plan. The plan involves major staff downsizing, modification of HUD's Field and Headquarters organizational framework, consolidation of HUD's programs and significant changes in the way HUD conducts its business. With the downsizing of staff and changes in organization, HUD sought new ways to conduct its business; such as the Requests for Proposals for outside contractors to administer HUD's portfolio of Section 8 contract.

HUD is seeking to achieve the following objectives through contracting with Public Housing Agencies to administer Section 8 Contracts:

1. Improve the administration of project-based Section 8 HAP contracts;
2. Encourage participation by new entities by broadly defining Public Housing Agencies to include joint ventures between governmental entities and private entities in delivering contract administration services;
3. Enter into contracts only with entities which have the required qualifications and expertise in the oversight and management of affordable housing, and, that have the capacity to perform required services with the requisite personnel and resources

## ***Objective, Scope and Methodology***

Our objectives are to examine the operations of several Contract Administrators in New England in anticipation of the Department's plans to increase the number of Section 8 contracts to be administered by outside contractors as part of the HUD 2020 Management Reform Plan; and to pro-actively identify issues that could affect the Department's plans.

Our review focused on five areas: Physical Inspections, Leasing and Occupancy, Financial Monitoring, Requisition of Subsidy and Administrative Fees paid to Contract Administrators. We selected six Contract Administrators including housing finance agencies, public housing authorities and departments of state governments. We conferred with staff in each of the New England Field Offices; as well as, the Deputy Assistant Secretary and his staff. We reviewed draft Requests for Proposals. Our review was conducted between April and August, 1998

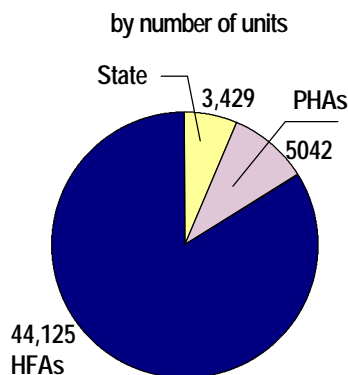
### ***Contract Administrators in New England***

Contract Administrators administer projects for HUD in each New England State as follows:

	<b>CT</b>	<b>MA</b>	<b>ME</b>	<b>NH</b>	<b>RI</b>	<b>VT</b>	<b>Total</b>
Total Projects	128	193	164	69	107	93	754
Insured	34	36	11	3	21	2	107
Non-Insured	94	157	153	66	86	91	647
Total Contract Units	10,344	22,118	5,215	2,574	10,288	2,057	52,596

There are three types of Section 8 Contract Administrators in New England: Housing Finance Agencies (HFAs), Public Housing Authorities (PHAs), and Departments within State governments (State). HFAs comprise the largest administrators in New England.

### **Contract Administrators in New England**



### ***Review of sample Contract Administrators***



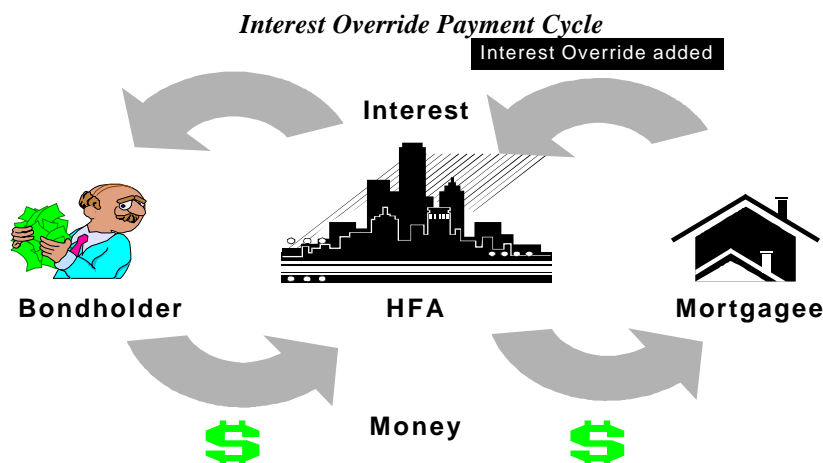
We examined the operations at three HFAs, two Public Housing Authorities and one State Agency who collectively administer 32,253 units or 61% of the units under contract administration in New England. We did not find any problems at the HFAs. The State Agency was not monitoring timely nor following up on identified problems. The State Agency attributed its difficulties to its recent staff cutbacks and reorganizations. The Public Housing Authorities were not performing all of the functions required; but were receiving full fees. The Public Housing Authorities did not believe that they were responsible for all of the required functions since HUD staff initially performed some of the functions for HUD-insured projects.

### ***Housing Finance Agencies (HFAs)***

Six Housing Finance Agencies administer contracts in New England. We reviewed the operations of three HFAs—Massachusetts Housing Finance Agency, New Hampshire Housing Finance Agency and Rhode Island Housing Mortgage Finance Corporation—and found that they were conducting annual physical inspections, reviewing the eligibility of tenants through annual occupancy reviews, monitoring the financial conditions of the properties and processing requisitions in accordance with HUD requirements. The HFAs had established systems to identify existing and potential problems in the areas of Physical Inspection, Requisitions, Occupancy, and Financial Reviews. The HFAs in our sample employed adequate staffing to maintain their systems and complete the monitoring of the projects under their administration.

The HFAs had a financial interest in most projects under their administration. The HFAs in our sample had provided the mortgage to 91% of the projects for which they were the Contract Administrator. These HFAs treated projects without an HFA mortgage the same as projects with an HFA mortgage. Projects without an HFA mortgage were insured, generally, by HUD. For the insured projects, we found that HUD was also performing periodic physical inspections, reviewing audited financial statements and periodically examining the eligibility of tenants. For their services, the HFAs received an administrative fee that was set up as either a flat fee per unit or an interest override payment. Regulations define the flat fee as 3 percent of the adjusted, local two-bedroom Fair Market Rent per unit. For the 16,744 units subject to a flat fee in our sample, the fee averaged \$29 per unit per month.

HFAs also received an indirect administrative fee in the form of an interest override payment. HFAs generate funds through the sale of bonds. HFAs use the bond funds for operating capital and to provide mortgages to build or renovate multifamily housing. The mortgagee pays interest to the HFA on the mortgage. The HFA pays interest on the bonds to the bondholder. The mortgagee interest is an additional 0.5 percent to 0.75 percent for the interest override payment.



Interest override payments are intrinsically tied to repayment of the mortgage. In the first half of the mortgage term, mortgage payments are primarily interest. As such, interest override payments are at high levels. In the later half of the mortgage term, the mortgage payments are primarily principal, so the interest override payments are at lower levels. Most of the mortgages in New England that are tied to interest override payments are in their later years. Because the cash flow on the interest override payments declines over the life of the associated mortgages, interest override payments in any given year are not useful in quantifying and projecting administrative fees. Fifty-nine percent of the projects in our sample have been subject to interest override payments during the life of the loan.

Many of the bonds supporting the mortgages were refinanced in the early 1990s in accordance with the Financial Adjustment Factor (FAF) program. Under this program, the bonds issued by the HFAs are refinanced at a lower interest rate and the savings are shared between HUD and the HFA. The bonds supporting the mortgages at 88 projects were refinanced.

We learned that two of the three HFAs are receiving interest override payments and flat fee administrative fees. Section 883.606 (b) of the 24 Code of Federal Regulations advises that HFAs can have either a flat rate fee or an interest override payment. This condition was previously reported in OIG's Interim Audit of Bond Refundings of Section 8 Projects Report Number 93-HQ-119-0004 and OIG's Multi-Region Audit of Refunding of Bonds for Section 8 Assisted Projects Report Number 93-HQ-119-0013. There are still unresolved issues relating to the audit findings which are open in the Audit Management System.

### ***Public Housing Authorities***

Fifty-eight Public Housing Authorities administer contracts comprising 5042 units or 10% of the inventory under contract administration in New England. We reviewed the operations of two public housing authorities and found that only one of the two was conducting annual physical inspections and processing requisitions in accordance with HUD requirements. Neither of the Public Housing Authorities were monitoring the financial

condition of the property nor were they examining the eligibility of tenants. These Public Housing Authorities advised that they were not aware that they were required to monitor the financial condition nor review the eligibility of tenants because initially HUD staff were performing these functions for the insured projects. These Public Housing Authorities advised that they had not performed either task for a number of years. While not performing all of the required functions, the Public Housing Authorities are receiving full fees.

The projects administered by these Public Housing Authorities were insured by HUD as are the majority (83%) of the projects administered by Public Housing Authorities in New England. If any of the insured projects fail, HUD must then pay off the outstanding debt on the mortgage.

### *State Agency*

State agencies in Connecticut and Vermont administer contracts comprising 3,429 units or 7% of the inventory under contract administration in New England. We examined the operations at the Connecticut state agency that administers 1,753 units. We found that they were not monitoring sufficiently, nor following up on identified problems. The State Agency attributed these issues to insufficient staff, organizational changes and lack of training.

This State Agency was receiving service fees on the mortgages in addition to its administrative fees. Connecticut State law allows the agency to charge service fees. For the four insured projects in their inventory, the state law's disregard of surplus cash may contravene federal regulations governing Section 8 subsidy. The State Agency believes the fees are legitimate because they initially provided funding for the projects.

### *Issues to be considered*

During our review, we identified several issues that we believe need to be addressed in order to successfully transfer the administration function of Section 8 HAP Contracts. To pro-actively assist HUD in the development of the new RFP, we brought these issues to the attention of the Deputy Assistant Secretary of Multifamily Housing Programs in our September 10, 1998 meeting.

1. **Cost-Benefit Analysis**: HUD's cost-benefit analysis of the wholesale (monitoring Contract Administrators) versus retail (monitoring project owners) methodologies dated August 1, 1997 shows that the wholesale operation cost over \$37 million more than the retail operation. However, the data used in this analysis is over one-year old and costs are based on the current methodology of paying administrative fees to Contract Administrators.

Regulations provide that flat-rate administrative fees are calculated as 3 percent of the adjusted, two-bedroom Fair Market Rent. In our sample of Contract Administrators,

this fee averaged \$29 PUPM. If we extrapolate that fee to units currently not under contract administration in New England on an annual basis, the administrative fee would exceed \$20 million.

\$ 29	per unit per month
58,135	units currently not under contract administration
x 12	months per year
<u>\$20,230,980</u>	cost of administrative fees in New England

The lack of a viable cost-benefit analysis was raised by the Inspector General in March and April of 1998. Housing officials advised that the redrafted RFP will contain a flat fee per unit per month for each task required under the RFP.

2. **Interrelationships**: The interrelationships between the Real Estate Assessment Center, the Section 8 Financial Management Center, the Enforcement Center, the Government Technical Monitors/Representatives, the Field Offices and the Contract Administrators need to clearly define the functions and roles of each. This could affect the amount of the Contract Administrator bids, avoid duplication of efforts and avoid conflicting dialogues with the project owners. Establishment of these Centers is a key component of the HUD 2020 Management Reform Plan with broad reaching effects to the proposals for Administration of Section 8 HAP contracts as well as many other HUD programs. Operations at these Centers are just beginning and HUD is still working on the details on coordination.
3. **Monitoring**: As mentioned in the OIG's March 31, 1998 Semi-Annual Report to Congress, HUD needs to effectively monitor contractor performance. HUD is establishing several Centers to assist the Department. Government Technical Monitors and Government Technical Representatives will remotely monitor the performance of Contract Administrators. The operation of these Centers will affect how HUD remotely monitors the performance of projects whose HAP contracts are being administered. The Financial Management Center is expected to review audited financial statements. The Real Estate Assessment Center is expected to perform physical inspections of the subsidized properties. The Enforcement Center will act for the Department in developing civil matters and referring them to the Department of Justice in order to enforce HUD's rights under the ACC and the HAP contracts. All of these tasks relate to Section 8 Contract Administration.

Monitoring, whether remote or onsite, is a tool used by management to identify non-performing Contract Administrators. HUD needs to develop procedures to deal with Contract Administrators experiencing problems and the potential removal of Contract Administrators. These procedures and the results of monitoring reviews of the Contract Administrators need to be communicated, not only to the Contract Administrators, but to all of the HUD Centers/Hubs working with the Contract Administrator or properties within the Contract Administrator's portfolio.

In addition to the Contracts Administrators to be hired under the Request for Proposals, HUD has 4,200 additional contracts being administered by current Contract Administrators. The draft version of the Request for Proposals plans to consolidate administration of these HAP contracts upon expiration of the current HAP contracts. HUD plans to consolidate all HAP contracts into one portfolio administered by the newly hired Contract Administrators unless the original Contract Administrator provided financing to the project. In New England, some HAP contracts handled currently by Contract Administrators will not expire until the year 2010 or later. Additionally, many of the HFAs currently providing contract administration also provided financing to the projects. Because of these facts, HUD needs to develop plans to monitor all of the Contract Administrators. It is unclear how Contract Administrators and HUD's new Centers will work together to resolve problems at projects. To resolve a problem, the coordination of information reported to the Contract Administrator, the Real Estate Assessment Center, the Financial Management Center, the Field Office and, in some cases, the Enforcement Center may be necessary.

One problem that current Contract Administrators are experiencing is called "shortfall." Shortfall occurs when the contract authority is not sufficient to provide rental subsidy for the year and the rental subsidy is less than the maximum rents permitted under the HAP contract. When shortfall occurs, the Contract Administrator has to submit additional documentation to request additional subsidy for a couple of months. HUD temporarily amends the contract in the tenth or eleventh month of the year to increase the Section 8 payments. The Contract Administrator found this exercise very frustrating because it is repeated annually and additional paperwork is unnecessarily created.

4. **Transfer of Responsibility:** HUD needs to identify the manner, timing and data that will be transferred between HUD and the Contract Administrator at the inception and the completion of the contract. The transfer of responsibility needs to take into account the tasks that HUD will perform as well as the tasks that the Contract Administrator will perform.

To assure a smooth transition, HUD needs to maintain accurate data in its computer systems and own the data provided to and compiled by the Contract Administrators in both written and electronic forms.

5. **Financial Interest in the Properties being managed:** HUD needs to be aware of any Contract Administrator's financial interest in the properties or any financial interest in the properties of an instrumentality acting on behalf of a Contract Administrator.

Currently HFAs have a financial interest as the mortgagee in many projects that they administer for HUD. We did not find any problems with this type of financial interest. Mortgages are only one type of financial interest; other types include, but are not limited to, management contracts with project owners, financial contracts for the investment of reserves, consulting contracts or identity of interest businesses providing services to projects. HFAs have raised questions re: providing additional services to the projects for

additional fees. HUD needs to be aware of these financial interests in order to evaluate the possibility of conflict of interest in the part of the potential Contract Administrator and to evaluate the propriety of the relationships.

6. **Staffing Plan:** HUD should be aware of the Contract Administrators' proposed staffing plan and be able to use that staffing plan to evaluate the bid and monitor performance under the contract. One of the Contract Administrators that we examined attributed its managerial problems to staff reductions and reorganizations. An entity may have sufficient staff at the inception of the contract. However, during the course of the contract, the entity may downsize or reorganize so that the remaining staff can no longer handle the workload.
7. **Expiration and Renewal of Section 8 contracts:** Our review of Section 8 Contract Administrators in New England found that many of the contracts under their jurisdiction were still on their original contract term. Many of the projects being administered by HUD have completed their original contract term and are subject to one-year renewals. HUD will need to identify the projects with one-year renewals and the data that HUD needs from the Contract Administrator to handle renewals. One-year renewals represent a greater workload than five-year or twenty-year renewals. Renewals require a lot of paper work and time which could affect the amount that a Contract Administrator bids. HUD needs to factor this workload in its evaluation of potential Contract Administrators.
8. **Training Contract Administrators to detect and report Suspected Fraud:** Contract Administrators acting on behalf of HUD will be the primary contact between HUD and the project owner or management agent. HUD needs to ensure that the Contract Administrators obtain sufficient training to detect and report suspected fraud including underreported income, poor workmanship, and equity skimming.
9. **Legal issues arising from Enforcement of HUD regulations by the Contract Administrators:** An HFA Director raised an issue about the costs of legal actions. Acting on behalf of HUD, Contract Administrators will have to take actions, such as abating Section 8 rents, that are not likely to be received well by the project's owners. In the past, project owners have sued HUD when HUD has taken action that project owners felt was not appropriate. HUD needs to develop procedures to address legal actions brought against the Contract Administrators to (1) protect the Contract Administrator when the Contract Administrator is acting lawfully on behalf of the Department and (2) protect the Department from unauthorized or illegal acts performed by the Contract Administrator that are contrary to or beyond the scope of their contract.