Issue Date September 16, 2005
Audit Report Number 2005-SE-1008

TO: Renee′ Greenman, Director, Multifamily Housing Hub, 0AH

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region X, 0AGA

SUBJECT: Idaho Housing and Finance Association, Boise, Idaho, Made Improper Section 8 Subsidy Payments and Improperly Distributed $7.2 Million of Bond Refund Proceeds Under its Non-insured, Subsidized Multifamily Projects Program

HIGHLIGHTS

What We Audited and Why

At the request of the Region X Multifamily Hub, we audited Idaho Housing and Finance Association (Idaho Housing) due to concerns that it (1) may have improperly allowed owners to prepay the mortgages of subsidized projects without the U.S. Department of Housing and Urban Development's (HUD) approval and (2) may not have properly implemented the conditions of HUD's approval of its proposed bond refunding in 1994 and that the bonds may not have been refunded.

Our overall audit objectives were to determine whether Idaho Housing followed federal regulations and HUD guidelines when it (1) allowed project owners to prepay project mortgages and (2) refunded bonds in 1994.

What We Found

Idaho Housing did not properly follow federal regulations and HUD guidelines when it allowed 10 project owners to prepay project mortgages. Prepayment caused the housing assistance payments contracts (contracts) to terminate, at which time the Section 8 subsidy amount should have been renegotiated with HUD. However, Idaho Housing continued to make subsidy payments to the projects after the contracts were terminated. This occurred because Idaho Housing misinterpreted the language in the contracts. As a result, HUD paid more than $8.5 million in subsidies in excess of fair market rents for these projects.

In addition, we found that Idaho Housing did not properly follow federal regulations and HUD guidelines when it refunded bonds in 1994 as part of a loan-restructuring plan for subsidized projects. It (1) did not return HUD's 50 percent share of the savings of $6,195,107 generated from the bond refunding for 30 McKinney Act projects, and (2) it did not use $997,523 of its 50 percent of the McKinney Act savings appropriately. This occurred because Idaho Housing believed that HUD's approval of the loan-restructuring plan allowed the agency to distribute the proceeds to the owners without regard to the McKinney Act provisions. In addition, Idaho Housing lacks the management controls to ensure that project owners receive only those distributions to which they are entitled. As a result, the McKinney Act savings were not available for HUD programs including those administered by Idaho Housing.

What We Recommend

We recommend that Idaho Housing be required to reimburse HUD and its federal programs from nonfederal funds for excessive subsidy payments on the terminated contracts and for inappropriately distributed bond proceeds. In addition, we recommend that HUD require Idaho Housing to keep HUD apprised whenever a project owner prepays the mortgage on a project subject to the old regulations and that HUD renegotiate the terminated contracts. Further, we recommend that HUD require Idaho Housing to implement procedures to ensure the proper identification of old regulation and new regulation projects with respect to the applicable regulations and guidance.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

Auditee's Response

We provided Idaho Housing Finance Association a draft report on July 28, 2005, and held an exit conference on August 17, 2005. Idaho Housing provided written comments on September 7, 2005. Idaho Housing Finance Association disagreed with most of the report. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix B of this report.

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BACKGROUND AND OBJECTIVES

Idaho Housing and Finance Association (Idaho Housing) is Idaho's housing finance agency. Idaho Housing does not receive state-appropriated funds for its operations. Its mission is to provide funding for affordable housing opportunities in Idaho communities where they are most needed and when it is economically feasible.

Idaho Housing participates in the development, finance, management, and tenant support for 59 projects under an annual contributions contract with the U.S. Department of Housing and Urban Development (HUD). Under this agreement, it functions as the agent for HUD in performing tasks in these areas as the Section 8 subsidy contract administrator. Idaho Housing's subsidy contract administration responsibilities include program compliance functions, to ensure that HUD-subsidized projects are serving eligible families at the correct level of assistance, and asset management functions, to ensure the physical and financial health of the projects. It processes the monthly housing assistance payments and is responsible for asset management functions, housing assistance payment contract (contract) compliance, and monitoring functions. It performs compliance reviews on these developments, including physical inspections and occupancy reviews. It holds and administers the replacement reserve, residual receipts, and all other appropriate escrow accounts for these projects and all other appropriate escrow accounts for these projects. It also processes the monthly housing assistance payments.

The monthly housing assistance payments are based on contracts between the owner and Idaho Housing. These contracts are categorized as either old regulation or new regulation. New regulation projects are those with a signed agreement to enter into a contract on February 29, 1980, or later.

Owners of old regulation projects are not limited as to the amount of distributions they may receive from the project, except that the distribution may only be made after funds have been set aside for or payment has been made for all project expenses. In addition, the contract for old regulation projects states that it terminates on the date of the last payment of principal due on the permanent financing.

Pipeline projects are treated like old regulation projects with respect to distributions. Although these projects are technically new regulation projects because the date of submission of the initial application was during a time of transition for HUD regulations, HUD allowed the projects to opt out of the limitation on distributions. Therefore, these projects, like old regulation projects, are not limited with regard to distributions.

New regulation projects are of two types: nonprofit and profit-motivated. Owners of new regulation nonprofit ownership projects are not entitled to distributions. Owners of profit-motivated new regulation limited distribution projects may only receive 6 percent (projects with elderly tenants) or 10 percent (family projects) of owner equity determined when the project was constructed. Owners of profit-motivated projects that are family projects with 50 or fewer units are exempt from the limitations on distributions. In this way, these projects are treated like old regulation projects. Additionally, the contract for new regulation projects states that the contract will remain in effect for at least 20 years, regardless of whether the mortgage is prepaid.

Our overall audit objective was to determine whether Idaho Housing followed federal regulations and HUD guidelines when it allowed project owners to prepay project mortgages and when it refunded bonds in 1994. We wanted to quantify any excess housing assistance payments made to prepaid projects because of contract termination. We also wanted to quantify any inappropriate equity takeouts on projects subject to the McKinney Act as well as other projects with limited distributions.

RESULTS OF AUDIT

Finding 1: Idaho Housing Continued to Make Subsidy Payments to 10 Projects after the Contracts Were Terminated

Idaho Housing made excessive subsidy payments to 10 old regulation projects after the contracts terminated with the payoff of the projects' permanent financing. Upon prepayment, the Section 8 subsidy should have been renegotiated with HUD. However, Idaho Housing continued to make subsidy payments to these projects, even after the contracts were terminated. This occurred because Idaho Housing misinterpreted the contracts to mean that as long as the project maintained financing or was responsible for debt service (e.g., through a refinance with Idaho Housing or another financial institution), the contracts remained in effect. As a result, the projects received more than $8.5 million of HUD Section 8 rent subsidies in excess of fair market rents, thus denying funds to subsidize other low-income individuals and families.

Contracts Terminated as a Result of Prepayment

We identified 10 old regulation projects in which the owners paid off the permanent financing provided by Idaho Housing. In accordance with Idaho Housing's contracts, the subsidized rents for the 10 old regulation projects were increased yearly, using an annual adjustment factor published in the *Federal Register*. The annual adjustment factor increases continued until HUD issued Notice H 95-12 in March 1995, enacting a rent freeze for projects with rents in excess of fair market rents. This freeze remains in effect until such time as the projects are able to submit a comparison showing that market rents for unassisted housing in the same market area of similar age, type, and quality are more than 105 percent of the current contract rent level for that unit type. The annual adjustment factor increases resulted in subsidized rents that were significantly higher than applicable fair market rents as follows:

Percentage of actual subsidized rents over applicable fair market rents since July 1, 1994, or date of prepayment (if later)			
Project	Rent paid	Fair market rent	Percentage of overpaid subsidies
Greenbriar	$ 4,515,699	$ 3,174,590	142%
Howard Place	3,217,132	2,652,458	121%
Market Lake Townhouses	84,589	54,970	154%
Oakridge	3,439,875	1,984,761	173%
Portneuf Towers	533,544	279,360	191%
Ridgeview	3,007,910	1,897,824	158%
Sandcreek	6,663,683	4,455,796	150%
Shoreline Plaza	2,931,151	1,816,723	161%
Tamarack	7,676	4,848	158%
Treehouse	1,711,323	1,236,726	138%

When the Idaho Housing loans were paid off, their housing assistance payment contracts were required to be automatically terminated as the contracts for old regulation projects state that the contract term shall not exceed "…a period terminating on the date of the last payment of principal due on the permanent financing." Thus, the subsidy payments should have ceased until the contracts were renewed, extended, or renegotiated with HUD. This would have provided HUD the opportunity to lower the subsidies to be more in line with fair market rents. However, Idaho Housing did not always inform HUD of the prepayments and continued to make subsidy payments to each of the projects as though the existing contracts were still in effect. Further, federal regulations at 24 *Code of Federal Regulations* 883.307(b)(2) state that when financing documents are to be substantially changed and those changes affect the Section 8 program, the housing agency must submit the revised documents for review. Accordingly, whenever a project's owner proposed to prepay or refinance the mortgage loan, Idaho Housing was required to submit the new financing documents to HUD for review because the prepayment terminated the project's contract.

Idaho Housing Has Paid More Than $8.5 Million in Excess of Fair Market Rents

We calculated the difference in the subsidy HUD paid for these projects and what the projects would have received at fair market rents. To make this calculation, we requested subsidy payment data from HUD. However, HUD was unable to provide us subsidy data earlier than the 1994-1995 fiscal year. Therefore, we calculated subsidies paid in excess of fair market rents from fiscal year 1995 forward for those projects that were prepaid before that time and from the time of prepayment for projects prepaid since 1995. As shown below, HUD has unnecessarily made $8,554,527 in subsidy payments in excess of fair market rents to Idaho Housing for the 10 prepaid projects.

Project	Month/year mortgage was paid off	Amount paid [1] (a)	Fair market rent (b)	Year end adjustment [2] (c)	Overpayment (a)-(b)-(c)
Greenbriar [3]	July 1993	$4,555,048	$3,174,590	$ 39,349	$1,341,109
Howard Place	April 1995	3,235,384	2,652,458	18,252	564,674
Market Lake Townhouses	November 2003	84,589	54,970	--	29,619
Oakridge [3]	July 1993	3,467,118	1,984,761	27,242	1,455,115
Portneuf Towers	March 2004	533,544	279,360	--	254,184
Ridgeview [3]	July 1993	3,029,055	1,897,824	21,145	1,110,086
Sandcreek	March 1994	6,699,584	4,455,796	35,901	2,207,887
Shoreline Plaza	December 2000	2,999,071	1,816,723	67,920	1,114,428
Tamarack	December 2004	7,676	4,848	--	2,828
Treehouse	January 1998	1,721,330	1,236,726	10,007	474,597
Totals		$26,332,399	$17,558,056	$219,816	$8,554,527

Idaho Housing Misinterpreted Contract Language

Idaho Housing staff told us that the language in the contract was not sufficiently clear on the subject of prepayment and the term of the contract. Consequently, they misinterpreted the contract to mean that the projects were only required to maintain permanent financing or have debt service.

[1] This is the total subsidy amount paid plus tenant rent since the mortgage was paid off.

[2] Subsidy returned to HUD by Idaho Housing after adjusting for actual occupancy rate.

[3] These projects were actually paid off some time before July 31, 1993, but Idaho Housing no longer had the actual dates.

Recommendations

We recommend that the director of multifamily housing

1A. Require Idaho Housing to reimburse HUD $8,554,527 for excess subsidy payments made for projects that did not have a valid contract.

1B. Require Idaho Housing to inform the local HUD office of future prepayments to ensure HUD has the opportunity to renegotiate the contract.

1C. Renegotiate the terminated contracts with the owners and Idaho Housing, taking into consideration the condition of the projects and fair market rents to allow funds to be put to better use in the amount of $1,339,881 over the next year.

Finding 2: Idaho Housing Did Not Follow Federal Requirements Regarding the Distribution of $7.2 Million in Bond-Refunding Proceeds

Idaho Housing did not return 50 percent of McKinney Act savings to HUD for 30 new and old regulation projects. The savings were generated from a 1994 bond-refunding and loan-restructuring program for the Section 8 new construction projects financed by Idaho Housing. Further, Idaho Housing did not always use its share of the savings in accordance with the requirements of the 1992 amendments to the McKinney Act. This occurred because Idaho Housing believed that HUD's approval of the loan-restructuring plan allowed the agency to distribute the proceeds to the owners without regard to the McKinney Act provisions. Consequently, HUD did not receive its $6,195,107 share of the loan-restructuring savings, and $997,523 of Idaho Housing's share of the savings was unavailable for its low-income housing programs.

Idaho Housing and Finance Association Did Not Return $6,195,107 in McKinney Act Savings to HUD

According to the 1992 amendments to section 1012 of the Stewart B. McKinney Homeless Assistance Amendments Act of 1988, HUD is required to return 50 percent of the amounts recaptured by projects from bond refinancing to the state housing finance agency. This implies that the remaining savings belong to HUD. The returned funds must be used to provide housing for low-income persons under an approved McKinney Act refunding agreement and housing plan or to pay allowable owner distributions. Although the housing finance agency may use its 50 percent of the savings to pay allowable owner distributions, the U.S. Department of the Treasury share (HUD's 50 percent of the savings) must be held harmless. HUD may not waive its portion of the savings.

In May 1994, Idaho Housing received approval from HUD for its overall proposal to conduct a loan-restructuring program for the Section 8 new construction projects that it financed. Under the loan-restructuring program, Idaho Housing refunded the bonds from which the original loans to the projects were made, restructured the loans, and used the savings to reduce the interest on the project loans. This enabled Idaho Housing to increase the projects' total loan principal amounts without raising the monthly payment amounts significantly and allowed owners to draw equity out of the projects without an increase in the subsidized rents.

Thirty of the projects that went through the loan restructuring are regulated under the 1992 McKinney Act amendments. The bond-refunding savings for these 30 projects totaled $12,390,213. However, Idaho Housing did not inform HUD that the projects were McKinney Act projects in its loan-restructuring proposal and did not submit McKinney Act refunding agreements and housing plans. If Idaho Housing's proposal had disclosed to HUD that the 30 projects were subject to the McKinney Act, HUD would have required the savings to be used to reduce the subsidized rents or to be deposited into trustee sweep accounts. Funds in the trustee sweep accounts would then be split between HUD and Idaho Housing in accordance with approved McKinney Act refunding agreements and housing plans.

Unlimited Distribution Projects

Twenty-four of the McKinney Act projects do not have restrictions on owner distributions. These projects are treated as old regulation projects and are not limited with regard to owner distributions after all project expenses have been paid. We determined it was appropriate for Idaho Housing to allow the distribution to the owners but only from its portion of the savings. However, $5,163,130 of the owner distributions of savings from the loan restructuring for these 24 projects should have been available to HUD in the trustee sweep accounts (see Appendix C).

Limited Distribution Projects

As a condition of HUD approval of the bond refund, Idaho Housing certified that it would comply with federal regulations at 24 *Code of Federal Regulations* 883.306 with respect to limitations on distributions for any new regulation project within the bond refund pool. Five of the McKinney Act projects are new regulation limited distribution projects. According to federal regulations at 24 *Code of Federal Regulations* 883.306, the owners of these projects are limited as to the distributions they may receive from the projects. Because these projects serve elderly tenants, the owners of the projects are limited to distributions of 6 percent on equity.

One of the McKinney Act projects was originally an old regulation project. However, in 1988, the owner of this project elected to amend the contract to adopt subpart G of 24 *Code of Federal Regulations* 883, which incorporates a limitation on distributions. The owner sold the project to The Housing Company, a nonprofit company, in 1992. The Housing Company assumed the existing mortgage and the contract, including amendments. As a nonprofit owner, The Housing Company is not entitled to distributions of project assets under the 1988 contract amendment.

Contrary to the McKinney Act amendments, Idaho Housing distributed HUD's $1,031,976 share of the McKinney Act savings and allowed $997,523 in excessive loan-restructuring program distributions to the owners of six projects (see Appendix D).

Idaho Housing staff told us that since it has a mixed portfolio of both old and new regulation projects, employees must have mistaken new regulation projects for old regulation projects during the bond refund. As a result, some new regulation limited distribution projects received equity takeouts to which they were not entitled.

HUD Should Have Received a Total of $6,195,007 in McKinney Act Savings

Total McKinney Act savings of $6,195,007 that should have been returned to HUD include the $5,163,130 distributed to the owners of the projects that do not have limitations on distributions and the $1,031,977 distributed to owners that should not have received any distributions or should have received only limited distributions. These savings should have either been used to reduce Section 8 subsidy payments to the projects or made available to HUD in a trustee sweep account.

Recommendations

We recommend that the director of multifamily housing require Idaho Housing to

2A. Reimburse HUD from nonfederal funds $6,195,107 for its share of the McKinney Act savings resulting from the 1994 bond refund.

2B. Reimburse its federal programs accounts from nonfederal funds the $997,522 for its portion of the McKinney Act savings that was not appropriately expended.

2C. Implement procedures to ensure the proper identification of old regulation, new regulation, and McKinney Act projects to prevent the further misclassification of projects, leading to excess (ineligible) distributions.

SCOPE AND METHODOLOGY

To achieve our audit objectives, we reviewed applicable federal regulations, HUD Handbooks, Idaho Housing written policies and procedures, and project files for the 59 projects under the annual contributions contract between Idaho Housing and HUD. In addition, we interviewed local HUD staff and Idaho Housing staff. We performed audit work at Idaho Housing's offices in Boise, Idaho, and at the HUD Multifamily office in Seattle, Washington, from November 2004 through June 2005. Our audit generally covered the period January 1, 2001, through December 31, 2004, and was expanded as needed.

We performed our review in accordance with generally accepted government auditing standards.

INTERNAL CONTROLS

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

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

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

Relevant Internal Controls

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

- Program operations – Policies and procedures that Idaho Housing has implemented to reasonably ensure that a program meets its objectives and that unintended actions do not result.
- Compliance with laws and regulations – Policies and procedures that Idaho Housing has implemented to reasonably ensure that resources used are consistent with laws and regulations.
- Safeguarding resources – Policies and procedures that Idaho Housing has implemented to reasonably prevent or promptly detect unauthorized acquisition, use, or disposition of resources.

We assessed the relevant controls identified above.

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

Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- Idaho Housing does not have controls in place to reasonably ensure that project funds are used consistent with federal regulations at 24 *Code of Federal Regulations* 883.306. Nor do management controls reasonably prevent or promptly detect the improper use of project resources (see finding 2).

APPENDIXES

Appendix A

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

Recommendation number	Ineligible 1/	Funds to be put to better use 2/
1A	$8,554,527	
1C		$1,339,881
2A	6,195,107	
2B	997,522	

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

2/ "Funds to be put to better use" are quantifiable savings that are anticipated to occur if an Office of Inspector General (OIG) recommendation is implemented, resulting in reduced expenditures at a later time for the activities in question. This includes costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

Idaho Housing and Finance ASSOCIATION

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September 6, 2005

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SUBJECT: Idaho Housing and Finance Association-Response to Draft Audit Report

Dear Ms. Hobbs:

Enclosed is the response of the Idaho Housing and Finance Association to the Draft Audit Report which was discussed in the exit conference held on August 17, 2005. We have assumed that there have been no changes to the draft report except as indicated in your letter to me dated August 22, 2005. We assume and expect that the entire enclosed response will be included in your final report of this matter and that if you intend to alter the findings in the audit report you will allow us an opportunity to respond to any changes. We also understand that we will have 24 hours notice of the posting of the audit report on your website.

If you have any questions on any of these matters or wish to discuss further, please let me know.

Sincerely,

Gerald M. Hunter

Gerald M. Hunter
President and Executive Director

Your Key to Housing Opportunities

IDAHO HOUSING AND FINANCE ASSOCIATION
RESPONSE TO FINDINGS OF THE OFFICE OF INSPECTOR GENERAL,
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

I. INTRODUCTION

The Idaho Housing and Finance Association (Association) categorically disputes the findings set forth herein by the Office of Inspector General (OIG), U.S. Department of Housing and Urban Development (HUD). Their recommendations are counter to long-standing practices and procedures followed by housing finance agencies throughout the nation, as directed and guided by HUD. Their attempt to impose financial penalties on the Association reflects a blatant disregard for HUD's own practices on these matters, recklessly impugns the integrity of the Association, and unjustly attempts to extort funding from Idaho's affordable housing programs.

In their first finding, the OIG attempts to overrule HUD's practice and policy of honoring the rental assistance contracts they have made with certain property owners to provide affordable housing in Idaho. The OIG hopes to void the terms and conditions of these contracts because the property owners simply chose to refinance their underlying loans. HUD's long-standing practice of honoring these contracts can be evidenced as recently as June, 2005, when HUD reviewed and approved the refinancing of ten similar Idaho properties without any change to the terms and conditions of applicable rental assistance contracts. The OIG attempts to rewrite these contracts by recovering payments from as far back as 1993, demanding the Association repay amounts it never received since contract payments are made to property owners for the maintenance and operation of affordable housing developments. The OIG undertakes this effort recognizing that neither HUD nor the OIG have performed a single onsite review of this Section 8 program since it's inception, almost 30 years ago.

In the their second finding, the OIG attempts to unravel a $31 million bond financing dating back to 1994, designed to preserve in perpetuity 36 Idaho affordable housing developments. The OIG wholly disregards HUD's prior evaluation and acceptance of this transaction, documented by HUD's own letter of approval. The OIG then erroneously calculates a grossly inflated bond financing benefit to which they claim half the amount. Again, the OIG turns to the Association and its limited affordable housing resources to pay this "so-called" savings, even though the financing benefits that were available flowed to property owners to ensure their commitment to perpetual affordability.

The Association has acted in good faith to follow HUD requirements and policy and to obtain HUD approvals when required. The Association did not benefit monetarily from any of these transactions, but rather, strived to promote and enhance Idaho's affordable housing resources. There is, however, question about the OIG's motivation in pursuing these findings and asserting the outrageous financial penalties reflected in their recommendations. First, the Association should not be used as a pawn in policy and regulatory disputes between the OIG and HUD. If the OIG has disagreements over HUD practices these should be resolved internally, without dragging the Association through an agonizing, costly, yearlong process of audits and illegitimate claims. The positions taken by the OIG, if implemented, will have far reaching

Comment 1

consequences to housing finance agencies throughout the country as indicated by the attached letter to the Association from the National Council of State Housing Finance Agencies set forth in Exhibit A hereto. Second, it appears the OIG may have unduly rushed its conclusions on this audit in order to reflect large "identified savings" on year-end performance reports. See the example set forth in Exhibit B hereto. The Association brought calculation deficiencies on so-called "savings" to the attention of the OIG during the exit conference, but without receiving serious consideration. It was also apparent the Association's allowable response time to the OIG audit report was limited by year-end report cut-offs.

A more detailed and specific discussion on each finding is set forth below:

II. SPECIFIC RESPONSES TO FINDINGS

A. OIG Finding 1: Idaho Housing and Finance Association Continued to Make Subsidy Payments to 10 Projects after the Contracts Were Terminated.

Comment 2

Finding 1 of the Draft Audit is based on a determination that the Section 8 Housing Assistance Payments ("HAP") Contracts on 10 projects were terminated due to a prepayment of the original project financing provided by the Idaho Housing and Finance Association ("Association") between July of 1993 and December of 2004. Although not clear from the Draft Audit, our understanding is that this finding is based on an opinion issued by HUD's General Counsel on June 23, 2002 ("2002 Opinion") which distinguished between the effect of the prepayment of State housing finance agency ("HFA") permanent financing on Old Regulation State Agency Section 8 HAP Contracts and New Regulation State Agency Section 8 HAP contracts. The 2002 Opinion strenuously denied that it was a reinterpretation of the Old Regulation HAP contract and HUD's prior practice and legal position. However, many knowledgeable practitioners in the affordable housing industry, including the leading organization representing State housing finance agencies, the National Council of State Housing Agencies, have strongly disagreed with the 2002 Opinion. Nor has the 2002 Opinion been tested in a court of law.

Comment 3

HUD has never issued any kind of broad notice to State HFAs, owners, or any participants in the Section 8 program advising them that Old Regulation Section 8 HAP Contracts were terminated upon the prepayment of the State HFA financing. In fact, the Association was not even made aware of the 2002 Opinion until it received a December 23, 2004 letter from the HUD Seattle Office indicating that research by the Seattle Office had revealed that the term of the Section 8 HAP contract may not exceed the term of the permanent financing. If HUD itself was unaware until December, 2004 that there was some internal HUD opinion on this matter that was not even disseminated widely in HUD, it is completely unreasonable to expect State HFAs and owners to be aware of this change in HUD policy and practice.

In fact, HUD's own ad hoc policy and practice since the issuance of the 2002 Opinion would evidence the very questionable policy results that could flow from the 2002 Opinion. Prior to the issuance of the 2002 Opinion, and as indicated in the

Comment 4

Comment 5

Comment 6

Comment 7

testimony of John C. Weicher, former Assistant Secretary of Housing-Federal Housing Commissioner before the Senate on October 9, 2002 ("Senate Testimony", a copy of which is attached as Exhibit C), there have been as many as 1400 projects that have been refinanced in accordance with State HFA and HUD requirements, and frequently with HUD's encouragement and approval, which could be adversely affected by the 2002 Opinion.

As indicated in the Senate Testimony, in order to "lessen the impact of this opinion on the existing assisted tenancies, minimize the loss of affordable housing units, and to assure the availability of continued rental assistance for project residents", HUD proposed to offer owners affected by the 2002 Opinion two options. The first option is to allow owners to "elect to extend the maximum term of the HAP contract from the date of the prepayment to terminate at the originally scheduled maturity date of the permanent financing". In effect, this option allows the Owner to continue to receive Section 8 HAP Contract payments on the same terms and conditions, including annual adjustment factor rent increases, until the original maturity date of the State HFA financing. We have attached as Exhibit D a copy of the form of HAP Contract Extension that HUD has drafted and provided on an ad hoc basis to owners and State HFAs where the issue has arisen. Recently, such contracts were entered into with HUD's approval, and we understand with the knowledge and consent of the Office of Inspector General for Audit, for some of the projects in a 10-project portfolio that was being refinanced by the Association with bonds and tax credits.

The second option offered by the Senate Testimony is for owners to elect to renew their contracts under the Multifamily Assisted Housing Reform and Affordability Act ("MAHRA"). Such a renewal could, presumably, include all of the renewal options provided under MAHRA including the possibility of marking the Section 8 rents up to market where the project qualifies under MAHRA. While such an election could also result in a reduction in over market rents, it must be emphasized that HUD has left the options to the choice of the owner and the owner is not required to renew under MAHRA. The Senate Testimony also raises the possibility that an owner could choose to opt out of the Section 8 HAP contract in which case the residents would be eligible for vouchers, including enhanced vouchers in situations where the Section 8 project-based rents were below market.

To the best of our knowledge, HUD has never stopped funding any Section 8 HAP contract on the basis that the contract had terminated upon the prepayment of the State Agency financing. Over the years, both before and after the issuance of the 2002 Opinion, HUD has continued to fund the Annual Contributions Contracts with State HFAs that are needed to make payments on such Section 8 HAP contracts without interruption, including the 10 projects that are the subject of this finding.

Finding 1 states that "upon prepayment, the Section 8 subsidy should have been renegotiated with HUD." We have several times asked for the legal rationale for the OIG's conclusion that the Association was under an obligation to renegotiate the rents with owners whose projects were refinanced, but have not received such rationale. There

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Comment 5

Comment 8

Comment 6

Comment 9

is absolutely nothing in Section 8 of the U.S. Housing Act of 1937, the State Agency regulations at 24 CFR part 883, or in the language in the Old Regulation Section 8 HAP contracts that justify the position stated by the OIG that the rents should have been renegotiated at the time of the refinancing. As indicated above, and assuming that the 2002 Opinion is a correct interpretation of the language in the contract, a position that we do not concede, HUD's stated policy and practice has been to allow owner's the option to extend the contract until the original maturity date of the State HFA financing on the same terms and conditions as the original contract.

There absolutely is neither legal basis nor logic in the Draft Audit conclusion that the rents on these contracts should have been renegotiated. The logical conclusion to the finding in the OIG Draft Audit is that if the contracts were in fact terminated, and the Association could not offer to extend the contracts on the same terms and conditions as the original contract, then no payments at all should have been made on the contracts. This, of course, would have made for an even more untenable position, not only for the Association, but for the many other State HFAs that have continued to make payments on such contracts for over the past 15 years, as well as for HUD which has continued to fund such contracts. As indicated above, HUD's clear policy has been to allow State HFAs to extend such contracts on the same terms and conditions as the original Section 8 HAP contract and until the original maturity date of the State HFA financing.

The only finding and recommendation that may be justified by the audit is that the Association should offer the owners of the 10 projects the option to extend the contracts on the form provided by HUD or to agree to now enter into a Section 8 renewal contract in accordance with MAHRA and the Section 8 renewal guide. The Association will, in fact, make such an offer to the owners of the projects in accordance with HUD's policy and on the form provided by HUD for such purposes. It is the Association's position that they have administered these contracts in complete compliance with all legal obligations and in accordance with HUD policies and that Finding 1 has no legal basis upon which to base a claim that the Association has paid rents in excess of those required under the Section 8 HAP contracts. If the OIG does not agree with HUD's policy, then the OIG should be addressing its concern to HUD and not using the Association as a pawn in its disagreement with HUD over this policy.

B. OIG Finding 2: Idaho Housing Did Not Follow Federal Requirements Regarding the Distribution of $7.2 Million in Bond --Refunding Proceeds

The OIG claims that the Association "did not return 50 percent of McKinney Act savings to HUD for 30 new and old regulation projects" and that, as a result, the Association owes HUD $6,195,107.[1] The Association owes HUD nothing. The OIG is wrong and recommendations 2A and 2B should be withdrawn for the following eight reasons. First, the McKinney Act - the law on which the OIG bases its claims - does not require the Association to return bond financing savings, if any, to HUD. Second, HUD itself has acknowledged that the McKinney Act places no explicit requirement on state

[1] Draft Audit at 11.

housing finance agencies to share any savings upon a refunding. Third, HUD approved the transaction at issue, including the Association's use of bond proceeds for restructured loans in exchange for project owners commitments for perpetual affordability for the projects, and the Association should be allowed to rely on that approval. Fourth, HUD has no contractual basis to require the Association to return any savings to it. Fifth, the Association's actions were wholly consistent with those of other state agencies at the time. Sixth, it is wholly unreasonable for the OIG to now seek to penalize the Association for a transaction that occurred *eleven years ago*. Seventh, there were never any real savings for HUD to recapture. Finally, the audit completely fails to consider important issues in calculating purported damages and fails to describe its methodology in its calculations.

This audit is simply the latest of a decades-long attempt by the OIG to force HUD to change its policy regarding recapture of savings; this audit has nothing to do with any improper actions by the Association. The OIG's audit findings are baseless and devoid of context, background, or justification. For the foregoing reasons and as described in more detail below, the OIG's recommendations regarding Finding 2 of the Draft Audit should be wholly withdrawn.

1. Factual Background

The OIG's claims center around a refinancing implemented by the Association in 1994. In 1994, pursuant to HUD approval, the Association refunded outstanding bonds issued in connection with thirty Section 8 new construction projects and restructured loans to owners in exchange for the owners' commitment to permanent affordability for their projects (the "1994 Refinancing"). Pursuant to the Section 8 Housing Assistance Payments ("HAP") Program for State Housing Agencies, state agencies like Association issued tax-exempt bonds during the late 1970s and early 1980s and loaned the proceeds to owners in order to finance Section 8 project construction. These tax exempt bonds were issued pursuant to Section 103 of the Internal Revenue Code of 1954 ("Section 103"). In contrast, local housing authorities often issued bonds pursuant to Section 11(b) of the United States Housing Act of 1937 (the "Housing Act"), thereby giving HUD more control over the bond issue. At the time of the refunded bonds involved in the 1994 Refinancing were originally issued, interest rates were at an all-time high.[2] Starting in the late 1980s and continuing through the mid-1990s, however, interest rates significantly declined, thereby presenting significant opportunities for the refunding of the high-interest rate bonds.[3] At the same time, many Section 8 project owners were paying off their loans and opting out of the project-based Section 8 program completely. Preserving the long-term affordability of the projects and retaining owners in the program was therefore

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[2] Office of Inspector General, Review of Savings from FAF Bond Refundings, 96-SE-119-0002 (Mar. 28, 1996) at 1.

[3] Summary of HUD Policies on Multifamily Housing and Refunding Transactions and Announcement of Certain Changes and Clarifications, Notice H-95-7 (Jan. 18. 1995) at 6-7.

HUD policy as well as the Association's mission. The Association recognized an opportunity to permanently preserve the affordability of the projects in its purview when it entered into the 1994 Refinancing that is the subject of this audit.

Comment 11

Specifically, the Association restructured its loans to borrowers by increasing the principal amount of the loans to a limited extent as a result of reduced bond interest rates and to a much larger extent due to the increased rents that had previously built up the HAP Contracts, with the result that the overall debt service on the loans was not reduced. The increased principal balance allowed project owners to withdraw a portion of their equity from the projects. In exchange, each project owner was required to "covenant to apply for additional Section 8 subsidy for the project, if available, when the current subsidy expires, and in any event to commit to a long term (over 50 years or permanent) low-income occupancy (60% or less, than area median gross income) of the projects."[4] As a result, the Association received no cash pay-out from these transactions; the proceeds which the Association derived from the refinancing were reinvested in the Section 8 projects to extend the affordable use restrictions on those projects.

Comment 12

Thus, the Association used the opportunities presented by the refinancing to implement HUD policy and preserve the long-term affordability of thirty projects in its purview. Given the large number of Section 8 owners opting out of the program entirely, the Association's actions not only secured the long-term affordability of thirty Section 8 projects, but were expressly approved by HUD and consistent with HUD's policies. Over a decade after the 1994 Refinancing, however, the OIG now seeks to penalize the Association for its actions.

Comment 13

2. <u>There is No Legal Basis for OIG's Recommendation 2A that the Association Reimburse Monies to HUD.</u>

a. <u>Section 1012 of the Stewart B. McKinney Homeless Assistance Amendments Act of 1988 (the "McKinney Act") was not intended to be applicable to the 1994 Refinancing.</u>

Comment 14

Without providing any background, context, or justification, the Draft Audit incorrectly asserts as if it were a foregone conclusion that "[t]hirty of the projects that went through the loan restructuring are regulated under the 1992 McKinney Act amendments".[5] However, neither the language of Section 1012 of the McKinney Act, nor its legislative history demonstrates that the Act was applicable to the refinancing of bonds in connection with non-FAF projects in the purview of state housing finance agencies ("State HFAs") like the Association. Instead, the McKinney Act was designed to apply to Section 8 projects which received a financial adjustment factor ("FAF") from HUD. The FAF

[4] Exhibit E, Letter from M. Ellersick to R. Duzy (November 5, 1993) at p. 1.

[5] Draft Audit at 12.

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Comment 15

provided additional Section 8 subsidies to address the skyrocketing interest rates of the late 1970s and early 1980s.[6] As a result of this added HUD investment, the HAP contracts for FAF projects generally contained a provision indicating that the contract rents had been processed pursuant to the FAF procedures contained in a 1981 FAF Memorandum. It also contained the following language with respect to possible future refundings: "In the event of a refunding of the bonds issued to finance the project, the Owner agrees to a reduction in the Contract Rents commensurate with the resulting decrease in mortgage debt service, and agrees that HUD may make a corresponding reduction in contract and budget authority for the project." There was no requirement in the contracts that an issuer of bonds participate in a bond refunding to reduce interest rates if circumstances later permitted such refinancing. Because HUD's policy position was that the HAP contracts further permitted HUD to recapture all the savings from these refinancings, there was little incentive for issuers to refund the bonds. Consequently, Congress enacted section 1012 of the McKinney Act to encourage, but again, not require, State Agencies to undertake bond refundings.[7] The HAP contracts associated with the 1994 Refinancings, which included only non-FAF projects, contained no provisions giving HUD any rights in connection with the bond refinancings or relating to reduction of the contract rents.

In non-FAF refundings, State HFAs generally retained all savings from bond refundings associated with non-FAF Section 8 projects.[8] In contrast, HUD retained all savings from bond refundings by State HFAs associated with FAF Section 8 projects. HUD also retained all savings from bond refundings by local housing agencies, regardless of whether such refundings were associated with FAF or non-FAF Section 8 projects. Section 1012, the product of successful lobbying efforts by State HFAs in 1988, required HUD to share with State HFAs 50 percent of recaptured amounts from refundings of Section 8 FAF projects.[9] The intent of Section 1012 was to provide an incentive to State HFAs to refinance bonds issued for Section 8 FAF projects at a time when interest rates had dramatically declined from the rates which existed when the bonds were initially issued and the FAFs were applied.[10]

The 1992 amendments to Section 1012 of the McKinney Act further extended HUD's responsibility to share savings by adding local

[6] Notice H-95-7 at 6.

[7] Notice H-95-7 at 9.

[8] Government Accounting Office, HUD Missed Opportunities to Reduce Costs on Its Uninsured Section 8 Portfolio, GAO/RCED-99-217 (July 1999) at 39.

[9] Notice H-95-7 at 9.

[10] Notice H-95-7 at 7.

housing agencies as recipients of the 50 percent of recaptured amounts and further applied the recapture provisions to the refinancing of non-FAF projects "constructed or substantially rehabilitated pursuant to assistance provided under a contract under Section 8(b)(2) of the United States Housing Act of 1937 ... entered into during any of the calendar years 1979 through 1984".[11] It is this latter provision, which is arguably applicable to non-FAF project contracts entered into between 1979 and 1984, which the OIG claims should apply to the 1994 Refinancing. However, as indicated in HUD's response to the July, 1999 GAO Report on Multifamily Housing, HUD's legal authority to require State HFAs to share non-FAF refinancing savings with HUD is dubious. HUD's response to the GAO Report states: "The report arguably mischaracterizes the requirements of Section 1012 of the McKinney Act, i.e., it states that the Act requires agencies to share 50 percent of any savings resulting from a bond refunding with the agency. Section 1012 places no explicit requirement on the agency to refinance projects, nor share any savings upon a refinancing. HUD rights in this regard are dependent upon the applicable regulation and contractual arrangements between HUD and the agencies. Committee Report language indicates that retroactive sharing was adopted in 1992 to allow HUD to compensate the 200 local Public Housing Authority issuers which participated in the HUD refunding program prior to McKinney enactment and received no savings. HFAs arguably could find ample basis to contest retroactive application of Section 1012 to these bond refundings. It must be recognized that the transactions at issue were done without HUD approvals. For non-FAF projects, there is no regulatory requirement for HUD approval of bond refundings that are not subject to HUD 11b regulations."

Comment 16

As indicated above, none of the projects in the Association's 1994 refunding were FAF projects and the OIG has pointed to no regulatory or contractual provision that would provide HUD with any rights in connection with these refinancings. In fact, in contrast to the non-FAF projects addressed in HUD's response to the 1999 GAO Audit, the Association with an abundance of caution sought and received HUD's approval of the 1994 refinancings

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Applying this provision to State HFAs like the Association, however, would contradict the legislative intent of Section 1012. As noted above, the 1988 version of Section 1012 was intended to provide a financial benefit to State HFAs for refunding FAF projects. The 1992 amendments were similarly intended to provide a financial benefit to local housing agencies that previously received no savings from refundings.[12] In contrast, applying the cost sharing provisions for non-FAF project

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[11] 42 U.S.C. 1437f note (2005).

[12] GAO/RCED-99-217 at 39.

Comment 14

refundings to State HFAs would actually create a *disincentive*, since State HFAs generally retained *all* cost savings from such refundings. Moreover, the legislative history of the 1992 amendments to the McKinney Act never addressed the applicability of the provisions to state agencies.[13] The McKinney Act simply provides no basis for the OIG's assertion that the Association now owes HUD over $6 million in supposed savings derived from the refinancing.

b. HUD has acknowledged that there is no explicit requirement in the McKinney Act to share any savings in refinancings like the 1994 Refinancing.

HUD itself has questioned the applicability of the McKinney Act to State HFAs that refund bonds connected to non-FAF projects.[14] A May 1993 legal opinion from HUD's Office of General Counsel acknowledged that the legislative history of the 1992 amendments to the McKinney Act did not address state agencies, thereby presenting strong evidence which State HFAs could use to challenge application of the recapture provisions.[15] HUD has further concluded that:

Comment 16

> Section 1012 places no explicit requirement on the [state] agency to refinance projects, nor share any savings upon a refinancing. HUD rights in this regard are dependent upon the applicable regulation and contractual arrangements between HUD and the agencies."[16]

By its own analysis and interpretation, therefore, HUD has acknowledged that the McKinney Act did not give HUD a right to cost savings from State HFAs that refinanced bonds associated with non-FAF projects. Such a right could only be contractual or regulatory and, as discussed below, no such rights were present in either the contracts or the regulations.

Moreover, HUD's interpretation of Section 1012 of the McKinney Act, as it applies to State HFAs, is entitled to judicial deference in a court of law.[17] HUD's statutory interpretation should therefore be given the same deference by the OIG that HUD would receive in a court of law.

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[13] GAO/RCED-99-217 at 40.

[14] See GAO/RCED-99-217 at 39.

[15] GAO/RCED-99-217 at 40.

[16] Comments from the Department of Housing and Urban Development, GAO/RCED-99-217 at 76.

[17] Chevron v. Natural Resources Defense Council, 467 U.S. 837 (1984) (holding that agency implementation of a statutory provisions should be granted great deference when Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority). Even if HUD's interpretation does not have the force of law, it is nonetheless entitled to deference. United States v. Mead Corp., 533 U.S. 218 (2001).

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Comment 18

3. HFA Should Be Entitled to Rely on HUD's Approval of the 1994 Refinancing.

HUD approved the 1994 Refinancing,[18] and the Association should be allowed to rely on HUD's approval. The Association initially requested HUD approval for the 1994 Refinancing on November 5, 1993 (*See* Exhibit E). Following this request, the Association engaged in extensive discussions with HUD Headquarters and Field staff and legal counsel regarding the refinancing, its goals, and the need for the long-term affordability commitments which the Association would obtain as a result of the refinancing. At the time of the 1994 Refinancing, HUD had not yet issued any guidance applicable to State HFAs that were refinancing bonds associated with non-FAF projects. All guidance from HUD, such as its Notice H-95-7 and other notices, came later and still did not clearly resolve the issue of what authority HUD had over non-FAF refundings. On May 17, 1994 the Association received HUD approval for the 1994 Refinancing. HUD's letter approving the 1994 Refinancing, attached as Exhibit F, (the "HUD Approval Letter") did not require the Association to remit to HUD or the U.S. Treasury half of all cost savings realized from these refinancings. The Association implemented the 1994 Refinancing only after it had obtained express HUD approval.[19] Just as the OIG should give HUD's statutory interpretation deference, HUD's approval is also entitled to deference.[20]

Furthermore, when HUD finally issued guidance and regulations, starting in 1995, HUD's guidance was consistent with its earlier approval of the 1994 Refinancing. For example, in January 1995 - nearly eight months after HUD approved the 1994 Refinancing - HUD first issued guidance governing the applicability of the McKinney Act to non-FAF projects (the "January 1995 Notice").[21] HUD generally intended for the notice to cover bonds issued under Section 103 (such as those involved in the 1994 Refinancing).[22] and did state that HUD should receive half of all savings from applicable

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[18] HUD approval was not required for at least 25 of the 30 refundings because they were old regulation HAP contracts. HUD approval was probably not even required for the remaining five refundings since those refundings were issued under Section 103 and not under the Housing Act. Nonetheless, IHFA sought HUD approval for the 1994 Refinancing because the agency wanted to ensure that HUD was comfortable with the transaction.

[19] The Draft Audit suggests that HUD would have requested costs savings from this transaction if IHFA had informed HUD that the projects involved in the transaction were McKinney Act projects. Draft Audit at 12. In fact, between the date of the Association's request to HUD for approval on November 5,1993 and the HUD approval on May 13, 1994, there were extensive discussions with HUD concerning all aspects of the loan restructuring program and HUD understood the financing and the program. Similar discussions were held in 2004 prior to the approval by HUD's Office of Asset Management of the Association request for approval of a similar refinancing and loan restructuring. Further, as discussed above, the McKinney Act did not apply to these projects -and HUD agreed with this interpretation. In addition, as discussed in subsequent sections of this response, at the time of the 1994 Refinancing, there was no written HUD guidance governing these non-FAF refinancings. IHFA should not be penalized for its reliance on HUD's approval.

[20] United States v. Mead Corp., 533 U.S. 218 (2001).

[21] Notice H-95-7.

[22] Notice H-95-7 at 3.

Comment 18

refundings.[23] However, the extent - if any - to which the guidance was even applicable to State HFAs was unclear:

> This Notice also does not purport to contain a comprehensive description of HUD's policies regarding state housing finance agency refundings of bonds issued to finance 100% Section 8 subsidized projects. Such transactions are governed in part by rules, regulations and precedents which do not apply to non-state HFA transactions. On the other hand, HUD believes that many of the guidelines set forth in this Notice should apply to state HFA transactions.[24]

This statement is further evidence of HUD's reluctance to state clearly that the McKinney Act applies to transactions such as the 1994 Refinancing.

It is worth noting that the Association's actions were nonetheless consistent with the January 1995 Notice. HUD explained:

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> While … HUD does not intend to open past transactions in the absence of exceptional circumstances, … HUD encourages state HFAs to discuss in advance transactions which they believe may not be required to comply with these guidelines.[25]

Comment 12
Comment 20

HUD clearly did not intend for this notice to be retroactive to the 1994 Refinancing. Even if it were applicable and required State HFAs to return cost savings from non-FAF project bond refinancing to HUD, the Association discussed in advance the transactions with HUD and obtained HUD's approval of a transaction in which any savings were reinvested in the Section 8 projects. Moreover, in May, 2004, HUD's Office of Asset Management again approved an Association request for approval of a similar refunding and loan restructuring, evidencing its continued intent in these matters.

The Association is entitled to rely upon HUD's approval of the 1994 Refinancing.

Comment 21

4. <u>The HAP Contracts Do Not Permit HUD to Recapture Any Savings.</u>

HUD has no contractual authority upon which to seek recapture of any purported savings. The HAP contracts associated with the 1994 Refinancing outline all the roles and responsibilities of HUD, the Association, and project owners in connection with the subject properties. As discussed above, the HAP contracts for non-FAF projects, such as those included in the 1994 Refinancing, do not contain any language either explicitly or implicitly permitting HUD to share cost savings. Accordingly, HUD has no contractual basis on which to obtain any purported savings from the 1994 Refinancing.

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[23] <u>See, e.g.</u>, Notice H-95-7 at 9-10, 24.

[24] Notice H-95-7 at 2.

[25] Notice H-95-7 at 2.

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Comment 21

Indeed, OIG Recommendation 2A would force HUD to breach the HAP contracts associated with the 1994 Refinancing. HUD has already faced a similar situation. In Cuyahoga Metropolitan Housing Authority v. United States, HUD, reacting to Congressional statute, required project owners to perform comparability studies before automatic annual adjustment factors ("AAF") could be applied to increase the rents on HAP contracts.[26] While this requirement was acceptable for future HAP contracts, HUD attempted to apply it retroactively to HAP contracts that had already been executed. The plain language of those executed HAP contracts, however, required automatic application of the AAFs unless HUD performed the comparability studies. In Cuyahoga, the Court of Claims found that HUD had no right to unilaterally modify the HAP contracts after they were executed.[27] Given this precedent, it is clear that the OIG's recommendation is not legally permissible.

5. The 1994 Refinancing Was Consistent with Other State HFA Refinancings

The Association's actions during the 1994 Refinancing were entirely consistent with the actions and understandings of many other State HFAs. In fact, in 1999 the General Accounting Office ("GAO") found that during the early to mid-1990s *none* of the state agencies whose actions it reviewed "shared savings for all contracts entered into between 1979 and 1984"[28] and that many state agencies refunded bonds associated with non-FAF Section 8 contracts issued between 1979 and 1984 and did not share the savings with the Federal government.[29] For the OIG to attempt to penalize the Association for a statutory interpretation that was consistent with the interpretation of other State HFAs is wholly unreasonable.

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Comment 23

6. The OIG's Findings Are Unreasonable Given the Length of Time That Has Passed Since the 1994 Refinancing

Comment 12
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Comment 23

The Association conducted the 1994 Refinancing pursuant to HUD approval. The Association did not profit from the 1994 Refinancing as all monies generated were reinvested to preserve affordable housing units. For the OIG to now attempt to punish the Association for preserving the long-term and permanent affordability of thirty Section 8 projects *eleven years* after the transaction occurred is legally unsupportable. It is worth noting that, in the administrative debarment context, an administrative law judge has found that it is improper for an administrative agency to attempt to debar an official six years after the offending behavior occurred.[30] Given the similar aspects of debarment actions and OIG audit findings, it is reasonable to use this six-year statute of limitations as a guideline for OIG audits and recommendations such as the ones in the Draft Report. It is fundamentally unfair, then, for the OIG to attempt to punish the Association for

[26] Cuyahoga Metropolitan Housing Authority v. United States, 57 Fed. Cl. 751 (2003).

[27] Id.

[28] GAO/RCED-99-217 at 42.

[29] GAO/RCED-99-217 at 41.

[30] In the Matter of Gary M. Wasson, HUDALJ No. 04-030-DB at 22.

actions which occurred so long ago - actions which, at the time, were consistent with available guidance from HUD and were specifically reviewed and approved.

7. There Were and Are No Real Savings for HUD to Recapture from the 1994 Refinancing.

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Comment 25

The Draft Audit identifies purported "savings" which never existed in the loan restructuring. Accordingly, there is no money for HUD to recapture. The Association never generated any real savings from the 1994 Refinancing. Debt service was never reduced and all proceeds from the refinancing were reinvested in the projects that were the subject of the 1994 Refinancing. The Draft Audit, however, fails to recognize this, and instead calculated savings using a simplistic and incorrect method. An example of this miscalculation with respect to one of the refinanced projects is set forth in Exhibit B hereto.

Comment 25

As evidenced from the limited information shared by the OIG with the Association, the Draft Audit calculates the cost savings derived from the 1994 Refinancing by taking the "total mortgage amount", calculated as "existing loan funds plus additional (equity take-out) loan funds", and then subtracting the existing mortgage transferred. This simplistic calculation does not reflect the actual terms of the transaction. For example, the increase in many of the loans can be attributed, in large part, to the increased rents to which owners were entitled under their HAP contracts as opposed to the refunding itself. The Draft Audit completely fails to consider that issue. Rather than taking this into account, the Draft Audit includes these amounts as surplus cash available as a result of the bond refinancings.

8. Recommendation 2B in the Draft Audit Improperly Recommends That the Association Should Reimburse Its Own Accounts by $997,522

a. The Draft Audit fails provide any mathematical justification for the $997,522 it claims was improperly distributed to owners.

Comment 26

The Draft Audit asserts that the Association should "reimburse its federal programs accounts from nonfederal funds the $997,522 for its portion of the McKinney Act savings that was not appropriately expended". However, the OIG provides no explanation of how it arrived at this amount. It simply asserts that this is the amount of money in excess of the limited distributions which the Association could properly distribute to owners of New Reg projects. Despite repeated requests, the OIG has refused to provide the Association with working papers or any further information on this matter which explain the basis for this rationale, thus the Association has no way to respond to the Draft Audit's allegations in connection with Recommendation 2B. Again, the OIG is not entitled to justify reimbursement of these amounts in the absence of any support.

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Comment 27
Comment 28

b. The Draft Audit mistakenly identifies Owyhee Place Apartments as a New Regulation Project.

The OIG Audit incorrectly labels Owyhee Place Apartments as a new regulation project; it was subject to the old regulations. Although a limited amendment to the HAP Contract for this project was executed in 1988 making certain portions of the New Section 8 Regulations applicable, the HUD Seattle office has acknowledged that this was not intended to be with limitation on distributions. The nonprofit status of the project is therefore irrelevant for purposes of the OIG's calculations. Accordingly, the portion which the Draft Audit claims was improperly allocated to the owners (the amount of which is never specified in either the Draft Audit) should be removed from the OIG's calculation of excess distribution to Owners.

Comment 29

9. This Audit Is Simply an Attempt by the OIG to Continue a Decade-Long Policy Dispute with HUD

This audit has nothing to do with any improper actions by the Association. Rather, it is part of an ongoing policy battle that the OIG has had with HUD since 1992. HUD has consistently challenged the OIG's recommendations as lacking statutory authority and undermining HUD's affordable housing preservation efforts.

OIG first challenged HUD's oversight of Section 8 bond refunding programs in 1992.[31] A further report was published by the OIG in 1993.[32] Both reports found that HUD did not always recapture savings from bond refundings, and recommended actions that HUD could take to realize additional savings. In 1996, the OIG published yet another report, this time focusing exclusively on HUD's failure to recapture savings from refunding of bonds in connection with Section 8 projects which received a financial adjustment factor ("FAF").[33]

Despite the OIG's continuing quest to impose a questionable statutory interpretation of the McKinney Act upon HUD, HUD refused to fully issue or implement a coherent policy applicable to state agencies who generate savings associated with non-FAF projects. In 1999, the GAO found that HUD had failed to issue clear guidance to state agencies on sharing with the Federal government savings associated with non-FAF projects.[34] The GAO further found that HUD "has not expressly required the state agencies to comply with the shared savings provisions in the ... 1992 amendment

[31] Office of Inspector General, Interim Audit Report: Bond Refundings of Section 8 Projects, 93-HQ-119-0004 (Oct. 30, 1992).

[32] Office of Inspector General, Multi-Region Audit of Refunding of Bonds for Section 8 Assisted Projects, 93-HQ-119-0013 (Apr. 30, 1993).

[33] Office of Inspector General, Review of Savings from FAF Bond Refundings, 96-SE-119-0002 (Mar. 28, 1996) at 1.

[34] GAO/RCED-99-217 at 8.

covering Section 8 contracts executed between 1979 and 1984".[35] The GAO additionally concluded that "[f]rom 1992 to early 1996, the Department [of Housing] took *no steps* to require the state agencies to share the savings from refunding bonds associated with contracts that ... (2) were entered into between 1979 and 1984 but did not receive special financing".[36] Thus, throughout the 1990s, HUD refused to apply the McKinney Act to State HFAs engaged in transactions like the 1994 Refinancing. This audit of the Association is simply another attempt by the OIG to force HUD to apply the OIG's unfounded statutory interpretation.

It is worth noting that Congress has not responded to the GAO Report's findings in 1999 that HUD has not applied the McKinney Act to State HFAs engaged in non-FAF project bond refinancings. If Congress believed HUD's interpretation of the McKinney Act was inconsistent with Congressional intent, Congress has had six years to pass clarifying legislation. It is not the role of the OIG to interpret housing statutes and regulations. This is HUD's role. It is not the role of the OIG to pass legislation. That is Congress' role. The OIG, therefore, is overstepping its bounds to impose an interpretation of the McKinney Act which is not supported by Congressional intent, HUD's explicit approvals, HUD regulation and guidance, or the actions of other State HFAs.

As set forth above, the Association's actions in connection with the 1994 Refinancing have been proper, diligent, and even commendable. By completing the 1994 Refinancing, the Association was able to permanently preserve 943 units of affordable housing in the state of Idaho, at a time when the Section 8 program was losing Section 8 project owners.

III. CONCLUSION

It is clear from the above discussion that the Association has been caught in the middle of an ongoing tug of war between HUD and the OIG over matters which occurred many years ago, from which it received no financial benefit and which the OIG now outrageously claims the Association should pay large sums of money that will be taken from Idaho's affordable housing programs. The findings here are unfounded and should be withdrawn.

[35] GAO/RCED-99-217 at 40.

[36] GAO/RCED-99-217 at 40 (emphasis added).

OIG Evaluation of Auditee Comments

Comment 1 The findings were discussed in detail with Idaho Housing and HUD during the course of the audit. Idaho Housing had the same time afforded to all other auditees to formulate its response. We provided Idaho Housing with written finding outlines in early July 2005 and sent our draft report to them on July 28, 2005. We considered all of Idaho Housing's positions raised at the exit conference and actually provided Idaho Housing a one week extension to their original due date to provide it more time to respond by September 7, 2005.

Comment 2 Our audit finding was not based upon HUD General Counsel's June 23, 2002 opinion. As noted in the report, the finding is based upon the requirements of the HAP contracts and federal regulations at 24 *Code of Federal Regulations* 883.307(b)(2). Idaho Housing's annual contributions contract with HUD states that it must comply and require owners to comply with the U.S. Housing Act of 1937 and all applicable regulations and requirements.

Comment 3 Although HUD never issued a formal notice stating that prepayment of old regulation project mortgages would terminate the contract, this should have been known by all owners as well as Idaho Housing. Within the contract itself, there is a provision that the contract terminates upon prepayment. Specifically, the contract states that the term of the contract ends on the date of the last payment of principal due on the permanent financing. Therefore, when a project is prepaid, the contract terminates.

Comment 4 Although the proposal to which Idaho Housing refers was discussed in Senate Testimony, it has not been formalized as a written HUD policy.

Comment 5 Our audit scope included only one of the ten projects to which Idaho Housing refers. We did not interfere with the sale and transfer of this project even though the prepayment would terminate the contract. This project was part of a package of nine other projects and it was our understanding that the deal would not go through without the inclusion of the project.

Comment 6 In order for HUD to stop funding the contracts due to contract termination, it would have to know that the projects were subject to the old regulations and that the projects were prepaid. However, as stated in the report, Idaho Housing did not always inform HUD of the prepayments and continued to make subsidy payments to each of the projects as though the existing contracts were still in effect.

Comment 7 We did not state that it was Idaho Housing or HUD's obligation to renegotiate the rents with owners whose mortgages were prepaid. However, in the interest of maximizing the effectiveness of the Section 8 program, we are recommending rents be renegotiated because we believe this should have been done. Lowering the Section 8 payments to market rates would have saved $8.5 million in subsidy payments that could have been used to provide rental assistance to additional low income persons.

Comment 8 We had no intention of questioning the entire amount of subsidy payments made after the contracts were terminated due to the refinancing. Subsequent to the termination of the HAP contracts, rental assistance was provided for the low income tenants of these projects. It would be unreasonable to recommend that Idaho Housing return the subsidies used to provide assistance at market rent rates. Consequently we are only recommending return of the subsidy paid in excess of fair market rents. These funds can then be used to provide rental assistance to other low income persons.

Comment 9 Idaho Housing should have known at the inception of the projects that the old regulation contracts terminate upon prepayment as this information is included in the project contracts. Further, Idaho Housing has had specific knowledge for nearly a year, since the HUD review in 2004, that old regulation contracts terminate upon prepayment. In spite of this knowledge, it has done nothing to rectify the situation. It has continued to make subsidy payments to each of the projects as though the existing contracts were still in effect. Therefore, we continue to recommend that Idaho Housing reimburse HUD for excessive subsidy payments made since the contracts terminated.

Comment 10 HUD Notice 95-7 also states that other HUD objectives in encouraging owners and housing finance agencies to refund bonds include reducing subsidy costs, recovering surpluses to which it is entitled, and improving projects' physical condition. Further, Idaho Housing implies the owners of these projects would otherwise opt out of the Section 8 program if they were not allowed to refinance with an equity take-out. However, we found that out of the projects that were part of the bond refunding, only one has current total rent levels below fair market rents. Therefore, it does not seem likely that the owners would opt out of the program since they were unlikely to generate the level of income received from the Section 8 subsidy.

Comment 11 Idaho Housing staff told us that the equity take-out to the owners was determined by calculating the amount of debt service the project could support at the current level of subsidy provided by HUD. If this equity take-out had not been provided to the owners, the debt service on the loans could have been reduced by the amount of savings we reported.

Comment 12 We agree that Idaho Housing did not receive funds from the bond refunding. However, the equity take-out funds were not returned to the Section 8 projects as implied by Idaho Housing's response. These funds were given to the property owners as an incentive to refinance.

Comment 13 The HUD approval referred to by Idaho Housing did not indicate in any way, that Idaho Housing did not have to abide by the provisions in the McKinney Act. In addition, when asked, Idaho Housing could not provide any documentation showing that it informed HUD that the projects referred to in its proposal were McKinney Act projects. It also could not provide us any documentation that HUD knew what specific projects were to be part of the refunding. Thus, it appears HUD's approval was most likely based upon incomplete information from Idaho Housing.

Comment 14 The Housing and Community Development Act of 1992 addresses Section 1012 of the McKinney Act and it states that projects qualified for sharing savings from a bond refunding include any State financed projects, constructed or substantially rehabilitated under a Section 8 contract during any of the calendar years 1979 through 1984, and that are being refinanced. This section applies to both Financial Adjustment Factor and non- Financial Adjustment Factor projects.

Comment 15 We agree that Section 1012 of the McKinney Act encouraged, but did not require State Agencies to refund bonds. However, when the State Agencies refund bonds, the McKinney Act provides that one half of the savings belong to HUD. HUD clarified its policies in its Notice 95-7 stating that local issuers (like State agencies) could share in the savings upon the refunding of bonds as long as they enter into a McKinney Act Refunding Agreement and Housing Plan to identify how the savings would be used to provide housing for persons of very low income. Idaho Housing neither submitted refunding agreements and housing plans, nor did it use all the savings for allowable purposes. Although HUD disagreed with the GAO report in 1999, Federal regulations and, HUD's guidance, prior to this report, at 24 *Code of Federal Regulations* 811.110(e) and HUD Notice 95-7 both require HUD and the housing finance agency to share in McKinney Act savings generated on bond refunds for non-financial adjustment factor as well as financial adjustment factor projects. Also, during the audit, we contacted HUD Headquarters program staff regarding McKinney Act projects and were told that Idaho Housing would have been required to set up a trustee sweep account and HUD would receive 50 percent of the savings and Idaho Housing would receive the other 50 percent or the rents would have to be reduced at the projects.

Comment 16 We agree that Section 1012 does not place an explicit requirement on the agency to refinance projects. However, this section states, "The Secretary shall make available to the State housing finance agency in the State in which a qualified project is located, or the local government or local housing agency initiating the refinancing of the qualified project, as applicable, an amount equal to 50 percent of the amounts recaptured from the project (as determined by the Secretary on a project-by-project basis)." Since 50 percent will be made available to the housing finance agency, it is implied that the other 50 percent should be returned to HUD.

Comment 17 Idaho Housing could not produce documentation supporting extensive discussions with HUD documentation when requested (see also Comment 13).

Comment 18 Idaho Housing states in one sentence that HUD intended that it should receive half of all savings from applicable refundings such as the refunding initiated by Idaho Housing and then says that HUD was reluctant to state clearly that the McKinney Act applied to these transactions. However, if one looks outside HUD Notice 95-7, and into the McKinney Act itself, one will see that the McKinney Act applies to these projects (see Comment 14).

Comment 19 In our opinion, the 1994 bond refunding represents an exceptional circumstance. Idaho Housing did not share the savings resulting from the bond refund with HUD and $6,195,107 was not available to provide rental assistance to additional low-income persons.

Comment 20 On May 12, 2004, HUD’s Office of Asset Management responded to Idaho Housing’s request for approval by restating the proposed terms of the refunding and loan restructuring, then referring Idaho Housing to the HUD Seattle office. Idaho Housing then wrote to the HUD Seattle office requesting written approval of the Modification Agreement and the Mortgage Loan and Refunding Commitment. The HUD Seattle office informed Idaho Housing that it was not willing to approve these documents due to several concerns including issues dealing with (1) McKinney Act savings, (2) renegotiation of subsidies upon the termination of the housing assistance payments contract, (3) distributions to owners of limited distribution projects, and (4) subsidies in excess of fair market rents. HUD’s Seattle office said it would entertain a revised proposal considering all of HUD’s concerns. There has been no further correspondence regarding this refunding.

Comment 21 The housing assistance payments contracts do not prohibit HUD from recapturing savings resulting from bond refunds as implied by Idaho Housing. In fact, the housing assistance payments contracts in question are silent on the issue. However, the annual contributions contract between Idaho Housing and HUD states that Idaho Housing must comply and require owners to comply with the U.S. Housing Act of 1937 and all applicable regulations and requirements. The McKinney Act is one such requirement (see Comment 14).

Comment 22 The GAO reported that some agencies shared savings from the bond refunding of non-Finance Adjustment Factor projects.

Comment 23 McKinney Act violations are a HUD program violation. As such, there is no general statute of limitations that applies broadly to claims brought pursuant to program violations.

Comment 24 Idaho Housing mischaracterizes OIG's intent with respect to this audit report. We are not working to punish or penalize program participants, but to ensure funds provided for low-income housing assistance are used effectively and free up funds to provide rental assistance to additional low income persons.

Comment 25 Idaho Housing staff told us that it calculated the amount of equity the owners could take out of the projects by determining the amount of debt service the projects could reasonably handle with the current level of HUD subsidy. The senior compliance manager said they used the cash flow in place and took out the estimated operating cost to determine the available debt service that the project could carry and the executive director said they wanted the debt service to stay the same so the housing assistance payments contracts wouldn't need to be adjusted. Therefore, if Idaho Housing had refunded the bonds without any equity take-outs, the resulting debt service would have identified savings to HUD as shown in our report.

Comment 26 At the exit conference, Idaho Housing staff requested an explanation on how we calculated the questioned amount. We explained at that time that these projects are limited distribution projects that Idaho Housing allowed an equity take-out in excess of that limitation. At that time, Idaho Housing staff disagreed that the equity take-out constituted a distribution and therefore, distributions to owners were not in excess of the limitations. After our exit conference, we provided a schedule to Idaho Housing showing how we calculated the questioned amount. We also provided HUD's definition of a distribution as "any withdrawal or taking of cash or any asset of the project other than for payment of reasonable expenses necessary to the operation and maintenance of the project." In addition, in a discussion with Idaho Housing staff on April 19, 2005, we explained that Idaho Housing certified to HUD that it would comply with regulations at 24 Code of Federal Regulations 883.306 with regard to limitations on distributions for any new regulation projects in the bond refunding pool. However, as shown in our report, it did not comply with this certification.

Comment 27 Idaho Housing, HUD, and the owner of the project amended the housing assistance payments contract in 1988 to adopt the new regulations at Subpart G of 24 Code of Federal Regulations 883. This subpart incorporates the limitation on distributions at 24 Code of Federal Regulations 883.306. Idaho Housing contends that the projects owners intended to opt out of the limitation on distributions. Further, Idaho Housing stated that there did not need to be any overt action to show that the owners opted out of the limitations. However, because the regulation specifically refers to the limitations and the amendment does not specifically opt out, we believe that this project is subject to the limitation. In addition, when the pipeline projects (old regulation projects that also adopted Subpart G) opted out of the limitations, there was an overt action to show that intent; i.e. the distribution limitation paragraphs were crossed out of the housing assistance payments contracts that were signed by Idaho Housing, HUD, and the owner.

Comment 28 HUD Seattle staff explained to us that they told Idaho Housing that they might have to retract the listing of projects as one type or another and that they wanted the OIG to look into the matter further. The Seattle staff also explained that they felt they had to send something to Idaho Housing to stop the current inappropriate activities but made Idaho Housing aware that OIG would review the matter. Also, at the request of Idaho Housing, the OIG added Appendix D to the report to show the excess distributions for each project.

Comment 29 Idaho Housing again mischaracterizes OIG's intentions. This audit and its findings were not undertaken as part of a policy battle with HUD. Contrary to this opinion, we initiated this audit at the request of the Region X Multifamily Hub due to concerns that Idaho Housing may not have properly implemented the conditions of HUD's approval of the refund.

Appendix C

INELIGIBLE COSTS – HUD'S PORTION OF MCKINNEY ACT SAVINGS (Recommendation 2A)

HUD's portion of McKinney Act savings		
McKinney Act projects	Total McKinney Act savings	Ineligible
1 Treated as old regulation projects		
Burrell Street Station	$854,433	$427,216
Cherrywood Apartments	863,744	431,872
College Park Apartments	213,494	106,747
Franklin Grove	775,868	387,934
Harrison Hills	402,245	201,122
Hazel Park	624,790	312,395
Parkview Center	289,220	144,610
Pioneer Square Apartments	891,479	445,739
Richlin Townhouses	332,443	166,221
Riverwood Apartments	18,178	9,089
Saturn Apartments	973,775	486,887
Shadow Mountain	294,803	147,402
Southside Apartments	91,947	45,974
Tamarack	434,930	217,465
Wildwood	593,014	296,507
Windwood	344,550	172,275
Millcreek Apartments	450,027	225,014
Payette Plaza	218,750	109,375
Van Engelen	183,869	91,935
Adams Lane	235,658	117,829
Meadowbrook	276,298	138,149
Payette Townhouses	157,914	78,957
Southdale Apartments	210,945	105,473
Snow Mountain	593,886	296,943
2 New regulation limited distribution projects		
Aspenwood	461,267	230,633
C Street Manor	141,973	70,986
Eagle Manor	527,829	263,915
Silver Hills	249,395	124,698
Westside Court	437,102	218,551
3 Nonprofit projects		
Owyhee Place Apartments	246,387	123,194
Totals	$ 12,390,213	$ 6,195,107

Appendix D

FIFTY PERCENT – EXCESS DISTRIBUTIONS

	McKinney Act Savings	IHFA's 50%	Allowable Distribution	Excess Distribution
Aspenwood	$461,267.00	$230,633.50	$6,764.00	$223,869.50
C Street Manor	141,973.00	70,986.50	7,137.00	63,849.50
Eagle Manor	527,829.00	263,914.50	9,101.00	254,813.50
Owhyee Place	246,387.00	123,193.50	-	123,193.50
Silver Hills	249,395.00	124,697.50	5,769.00	118,928.50
Westside Court	437,102.00	218,551.00	5,683.00	212,868.00
	$2,063,953.00	$1,031,976.50	$34,454.00	$997,522.50