



Issue Date

August 19, 1996

Audit Case Number

96-FW-214-1002

TO: James E. Hicks
Director, Office of Housing, 6AH

FROM: D. Michael Beard
District Inspector General for Audit, 6AGA

SUBJECT: Credit Finance Corporation
Multifamily Management Agent
Dallas, Texas

We completed a limited review of Credit Finance Corporation's (CFC's) payments for boiler and machinery insurance. The purpose of the limited review was to determine if boiler and machinery insurance expenses paid for with project funds were reasonable and in accordance with Regulatory Agreement and HUD requirements. The review resulted from a separate examination of work papers of CFC's Independent Auditor¹. The Independent Auditor's work papers disclosed problem indicators relating to boiler and machinery insurance payments.

We: (1) examined the Independent Auditor's work papers for three selected projects managed by CFC (Highland Hills, Park Creek Manor, and Rolling Meadows); (2) reviewed checks and supporting documentation provided by CFC's president; (3) interviewed officials of the Independent Auditor, CFC, the Texas Department of Insurance, and HUD Offices of Housing and Counsel.

We conducted the review in accordance with generally accepted government auditing standards. We performed the review in December 1995 and February 1996. The review covered the period August 1993 through December 1994.

¹ We recently audited CFC's activities and issued a report on October 16, 1995 (report no. 96-FW-214-1001). During the audit, nothing came to our attention that indicated problems with boiler and machinery insurance payments.

SUMMARY

Based on problem indicators found during an examination of the Independent Auditor work papers, we performed a limited review of Credit Finance Corporation (CFC) payments for boiler and machinery insurance. The review found that CFC disbursed at least \$87,700 in project funds for invalid boiler and machinery insurance. The "insurer" and CFC's president lacked legal authority to sell insurance to the projects. Consequently, nine HUD projects, including three projects in default, paid for services they never received. This occurred because CFC's president ignored or did not adequately consider applicable State insurance laws and the impact of HUD requirements. We are recommending you require the owners and CFC to repay the projects for the unallowable insurance payments and obtain valid boiler and machinery insurance as needed.

INTERNAL CONTROLS

An assessment of internal controls was not necessary to satisfy the review objectives. As such, we did not perform a review of internal controls.

* * * *

Within 60 days please give us, for each recommendation made in the report, a status on: (1) corrective action taken; (2) the proposed corrective action and the data to be completed; or (3) why action is not considered necessary. Also, please furnish us copies of any correspondence or directives issued related the audit.

If you have any questions, please contact me or Frank Baca, Assistant District Inspector General for Audit, at (817) 885-5551.

Appendices

Appendix A	Audit Finding and Recommendations	Page 3
Appendix B	Schedule of Ineligible Costs	Page 6
Appendix C	Payments for Boiler and Machinery Insurance	Page 7
Appendix D	Auditee Comments	Page 8

AUDIT FINDING AND RECOMMENDATIONS

FINDING - Projects Paid for Invalid Boiler and Machinery Insurance

Credit Finance Corporation (CFC) disbursed at least \$87,700 in project funds for invalid boiler and machinery insurance. The "insurer" and CFC's president lacked legal authority to sell insurance to the projects. Consequently, nine HUD projects, including three projects in default, paid for services they never received. This occurred because CFC's president ignored or did not adequately consider applicable State insurance laws and the impact of HUD requirements.

Regulatory Agreement and HUD requirements. The Regulatory Agreement for multifamily projects states owners shall not, without the prior written approval of the Secretary, pay out any funds, other than from surplus cash, except for reasonable operating expenses and necessary repairs.

Deeds of Trust require mortgagors to maintain insurance as HUD directs. HUD Handbook 4350.1 REV-1 (paragraph 21-4.C) requires the mortgagor maintain boiler and machinery insurance if the project has steam boilers. Also, HUD requires a standard form of boiler and machinery insurance policy (or policies) to evidence the insurance (Form FHA-2447, HUD Property Insurance Requirements, paragraph 5(d)).

State laws govern reciprocal insurance exchanges. Texas' Revised Civil Statutes, Article 19, allows entities to exchange reciprocal or inter-insurance contracts to ensure one another. Before beginning to operate, the exchange must file a declaration with the State's Department of Insurance with information required by statute. Also, the exchange's attorney-in-fact must provide information, meet fidelity bonding requirements, and obtain a Certificate of Authority to act on the exchange's behalf.

Independent Auditor work papers indicate CFC misdirected project assets. Subsequent to the CFC audit, OIG staff performed a review of work papers of CFC's Independent Auditor for selected projects. The review found indicators of other statutory and regulatory violations in the agent's operations relating to boiler and machinery insurance. The Independent Auditor's Boiler & Machinery Coverage work paper stated:

"The B&M policy with Kingsport was cancelled 7/28/93. A bid was obtained with Kemper but was rejected.... Ten projects contribute to a fund set up by CFC to cover repair needs in this area. Contributions to this fund began in August 1993."

Nine of the ten projects the work paper referred to are HUD insured properties. The Independent Auditor provided a copy of a Travelers boiler insurance policy, which indicated a July 31, 1995 effective date. However, as of December 1995 CFC's president said the Traveler's policy hasn't

gone into effect yet. The projects still have insurance through a reciprocal insurance exchange.

Projects lack bona fide insurance coverage. CFC contends the projects had insurance, but could not provide a bona fide insurance policy as proof of coverage for amounts the projects paid for boiler insurance. The CFC president provided a reciprocal insurance exchange policy, which he signed as "Authorized Representative." Texas Department of Insurance officials said they have no record the reciprocal insurance exchange has authority to operate in Texas. Further, the Texas Department of Insurance officials examined the policy and stated the policy was incomplete. It did not identify the insurance company or have a policy number and contained a form (Energy Express Coverage) that was not standard or State-approved. CFC's president said he and the projects formed a reciprocal insurance exchange. The CFC president was its agent, the exchange issued the policy, and the policy had a policy number.

CFC sold insurance policies violating state insurance laws. The HUD Office of Counsel in Fort Worth confirmed that CFC violated Texas insurance laws. HUD's attorney said Texas law requires reciprocal insurance exchanges (and their attorneys-in-fact) to meet statutory filing, bonding and certification requirements before selling insurance. Yet, the Texas Department of Insurance has no record CFC, its president, or the Boiler & Machinery Insurance Reciprocal Insurance Exchange met the requirements. The exchange issued the policy without authority. And, CFC's president appeared to act as the exchange's attorney-in-fact without meeting statutory requirements to represent the exchange. Also, HUD's attorney suggested project file reviews be made to determine whether the projects need the boiler and machinery insurance.

Projects paid at least \$87,700 for invalid boiler insurance. CFC provided checks and other records identifying \$87,700 in payments the nine projects made for boiler insurance from August 1993 through December 1994 (see Appendix C). Three of the nine projects (Highland Hills, Park Creek Manor, and Woodland City) were in default during this period. Further, based on a review of the Independent Auditor's work papers for two projects, the projects likely paid more than the \$87,700 for the period. CFC records showed Highland Hills and Rolling Meadows as making 8 and 11 monthly payments, respectively, during 1994. However, the Independent Auditor's 1994 work papers show Highland Hills made 10 payments and Rolling Meadows made 12 payments.

Auditee Comments

CFC's president declined an exit conference. He sent a written response dated June 18, 1996 (see Appendix D). The written response expressed disagreement with the finding but did not provide details. The response stated CFC would have their insurance consultant provide an independent response after issuance of this report.

Recommendations

We recommend the Fort Worth Office:

- 1A. Except for Park Creek Manor, require the owners and CFC to reimburse the projects \$83,700 for identified improper boiler and machinery insurance payments made from project funds from August 1993 to December 1994.
- 1B. Require the owners and CFC to reimburse HUD \$4,000 for improper boiler and machinery payments relating to Park Creek Manor.
- 1C. Obtain and review project accounting records to identify any other improper boiler and machinery insurance payments made in 1993 and 1994, as well as improper payments made since 1994, and require the owners and CFC to reimburse the projects.
- 1D. Review HUD files and, if necessary, inspect the eight projects CFC still manages to determine whether the projects need boiler and machinery insurance.
- 1E. For projects identified as needing boiler and machinery insurance, require the owners and CFC to obtain valid boiler insurance and provide documentation to the Field Office.
- 1F. Impose appropriate administrative sanctions and civil actions against the owners and CFC for violating the Regulatory Agreements and HUD guidelines if the owners and CFC do not make required repayments and take necessary corrective action.

Schedule of Ineligible Costs

<u>Recommendation Number</u>	<u>Ineligible²</u>
1A	\$83,700
1B	4,000
TOTAL	<u>\$87,700</u>

² Costs clearly not allowed by law, contract, HUD, or local agency policies or regulations.

Appendix C

		Credit Finance Corporation Payments for Boiler & Machinery Insurance									
Check Date	Number	EI Capitan	Eules Square	Highland Hills	Leigh Ann	Oak Hollow	Park Creek Manor	Prairie Creek Manor	Rolling Meadows	Woodland City	
08/20/93	13194	800	800	1,000	600	500	500	800	800	700	
09/20/93	13255	800	800	1,000	600	500	500	800	800	700	
10/20/93	13328	800	800	1,000	600	500	500	800	800	700	
11/20/93	13387	800	800	1,000	600	500	500	800	800	700	
12/20/93	13510	800	800	1,000	600	500	500	800	800	700	
01/20/94	13570	ck missing	800	800	1,000	600	500	500	800	700	
02/20/94	13591		800	800	1,000	600	500	500	800	700	
03/20/94	13614	ck missing	800	800	1,000	600	500	500	800	700	
04/20/94	1148		800								
04/20/94	1167							800			
04/20/94	1191								800		
04/20/94	1223	800									
04/20/94	1227			1,000							
04/20/94	1308				600						
07/05/94	1259		1,600								
07/05/94	1294							1,600			
07/05/94	1303	1,600									
07/05/94	1344								1,600		
07/05/94	1382			2,000							
07/06/94	1236									1,400	
07/06/94	1239					1,000					
07/27/94	1491				600						
08/23/94	1303					500					
08/23/94	1360							800			
08/23/94	1454								800		
08/23/94	1561				600						
10/04/94	1351									700	
10/04/94	1372					500					
10/04/94	1420							800			
10/04/94	1461	800									
10/04/94	1526								800		
10/04/94	1633				600						
10/18/94	1671				600						
11/04/94	1414		800								

Appendix C

11/04/94	1476							800		
11/04/94	1515	800								
11/04/94	1587								800	
11/14/94	1434		800							
11/14/94	1490						800			
11/14/94	1623								800	
11/14/94	1710				600					
12/09/94	1457		800							
12/09/94	1546						800			
12/09/94	1569	800								
12/09/94	1629			1,000						
12/09/94	1630			1,000						
12/09/94	1670								800	
12/09/94	1764				600					
	TOTAL	\$11,200	\$11,200	\$13,000	\$9,000	\$6,000	\$4,000	\$12,800	\$12,800	\$7,700

Auditee Comments