

Issue Date	April 30, 2007
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Audit Report Number	2007-KC-0003
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TO: Brian D. Montgomery, Assistant Secretary for Housing –  
Federal Housing Commissioner , H

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FROM: Ronald J. Hosking, Regional Inspector General for Audit, 7AGA

SUBJECT: HUD Did Not Recapture Excess Funds from Assigned Bond-Financed Projects

## **HIGHLIGHTS**

### **What We Audited and Why**

We audited excess funds generated by the U. S. Department of Housing and Urban Development’s (HUD) mortgage insurance program. Excess funds are the amounts remaining under the trust indenture after the trustee uses mortgage insurance proceeds to redeem all outstanding bonds related to an assigned mortgage. This review was a followup to our audit memorandum (97-KC-1120-0801), issued in 1997, on HUD’s handling of excess funds. Our audit objective was to determine whether HUD properly identified, claimed, and collected excess funds.

### **What We Found**

HUD did not identify, claim, and collect excess funds generated by assigned bond-financed mortgages. It had inadequate controls over origination and assignment of bond-financed mortgages. As a result, for 33 projects reviewed, HUD failed to claim and collect \$2 million in excess funds. If it does not implement effective controls, it will continue to miss opportunities to claim and collect excess funds.

## **What We Recommend**

We recommend that HUD take appropriate actions to strengthen controls and ensure that excess funds are identified, claimed, and collected.

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 the draft report to the Office of Housing on March 15, 2007. The Office of Housing generally agreed with our findings and recommendations which we discussed during the exit conference on March 22, 2007. The Office of Housing did request some changes to the wording and/or presentation of some sections of the report. We worked with the Office of Housing on its request and made all changes we mutually agreed upon. Since we reached agreement on the content of the draft report, the Office of Housing decided not to provide written comments. Instead they indicated that our recommendations would be addressed in their Management Decision.

## TABLE OF CONTENTS

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Background and Objectives	4
Results of Audit	
Finding: HUD Did Not Recapture Excess Funds	5
Scope and Methodology	9
Internal Controls	10
Appendixes	
A. Schedule of Questioned Costs and Funds to Be Put to Better Use	11
B. Schedule of Excess Funds	12

## BACKGROUND AND OBJECTIVES

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U. S. Department of Housing and Urban Development (HUD)-insured mortgages are often financed with two types of tax-exempt bonds, Section 103(b) and Section 11(b). When a borrower defaults, the lender assigns the mortgage to HUD, and HUD pays the lender's insurance claim. On bond-financed projects, the lender remits funds to a bond trustee, who pays off the bondholders. Frequently, excess funds result when HUD pays a lender's insurance claim for more than is needed to pay off the outstanding bonds. Bonds issued before June 19, 1984, were exempt from federal taxation under Section 11(b) of the United States Housing Act of 1937. All bonds issued after that date are exempt from taxation under Section 103 of the Internal Revenue Code. HUD regulations implementing Section 11(b) required any excess funds remaining in the bond debt service reserve, after redeeming outstanding bonds, to be remitted to HUD. There is no similar provision for bonds issued under Section 103 of the Internal Revenue Code.

In 1997, OIG issued an audit memorandum on HUD's handling of excess funds related to defaulted insured mortgages financed with tax-exempt bonds. We reported that HUD's mortgage insurance payments exceeded the funds needed to pay the underlying bonds by \$17.1 million. We recommended that the Office of Housing, in conjunction with the Office of General Counsel, (1) publish regulations dealing with prospective accumulations of excess funds and (2) take specific actions to identify excess funds and ensure excess proceeds either benefit the housing developments and their tenants or offset HUD's mortgage insurance losses. In August 2000, HUD certified that it took appropriate corrective action and closed the recommendations.

Our objective was to determine whether HUD properly identified, claimed, and collected excess funds.

## RESULTS OF AUDIT

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### Finding: HUD Did Not Recapture Excess Funds

HUD did not identify, claim, and collect excess funds generated by assigned bond-financed mortgages. It had inadequate controls over origination and assignment of bond-financed mortgages. As a result, for 33 projects reviewed, HUD failed to claim and collect \$2 million in excess funds. If it does not implement effective controls, it will continue to miss opportunities to claim and collect excess funds.

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#### **HUD Did Not Identify, Claim, and Collect Excess Funds**

HUD's systems do not identify all bond-financed projects. According to HUD's systems, as of August 2006, HUD had more than \$4 billion in mortgage insurance in force on 404 bond-financed projects. During our audit period, there were 31 assignments totaling nearly \$171 million. However, these data are not complete. As an example, one multifamily lender has closed more than \$135 million in bond-financed mortgages since HUD started identifying bond financing in its systems. These projects were not identified as bond-financed mortgages in HUD's systems.

HUD was unaware of the amount of excess funds it was owed and did not claim any of these funds. For those projects that HUD's systems identified as bond-financed, it did not contact lenders or trustees and notify them of its claim on any excess funds. Occasionally, trustees would contact HUD to get instructions on how to handle the excess funds, and HUD would instruct the trustees to return the funds.

HUD did not collect excess funds or adequately track the unsolicited excess funds it periodically received. It maintained a spreadsheet for tracking excess funds, but the spreadsheet did not contain any receipts from assignments during our audit period. In one case, a trustee sent in the excess funds, but HUD staff did not record this collection on their spreadsheet.

In summary, HUD did not know what projects were bond-financed, how much was due HUD, and whether or not funds were collected.

#### **HUD Had Inadequate Controls**

HUD had inadequate controls over the origination and assignment of bond-financed projects.

## Origination

HUD did not have written guidance or effective computer systems to allow for identification and proper documentation of bond-financed projects during the origination process.

HUD did not have written guidance requiring

- Staff to obtain and review trust indentures for key information such as
  - Identity of trustee, issuer, and borrower,
  - Type of bond financing (103b or 11b),
  - Committee on Uniform Securities Identification Procedures (CUSIP) number, and
  - Intended disposition of final fund balances;
- Staff to effectively identify whether a project was bond financed; and
- Trust indentures to stipulate that excess funds be returned to HUD after redemption of all outstanding bonds with insurance proceeds.

HUD's key systems did not interact with each other, nor did they show all bond-financed projects. It used three separate systems (F-47, F-75, and the Real Estate Management System) to identify bond-financed projects. These systems were ineffective because they allowed HUD staff to enter "undetermined" or leave identification fields blank without any required follow up.

## Assignment

HUD did not have adequate written guidance addressing bond-financed projects during the assignment process for staff, lenders, or trustees. It did not have written guidance requiring

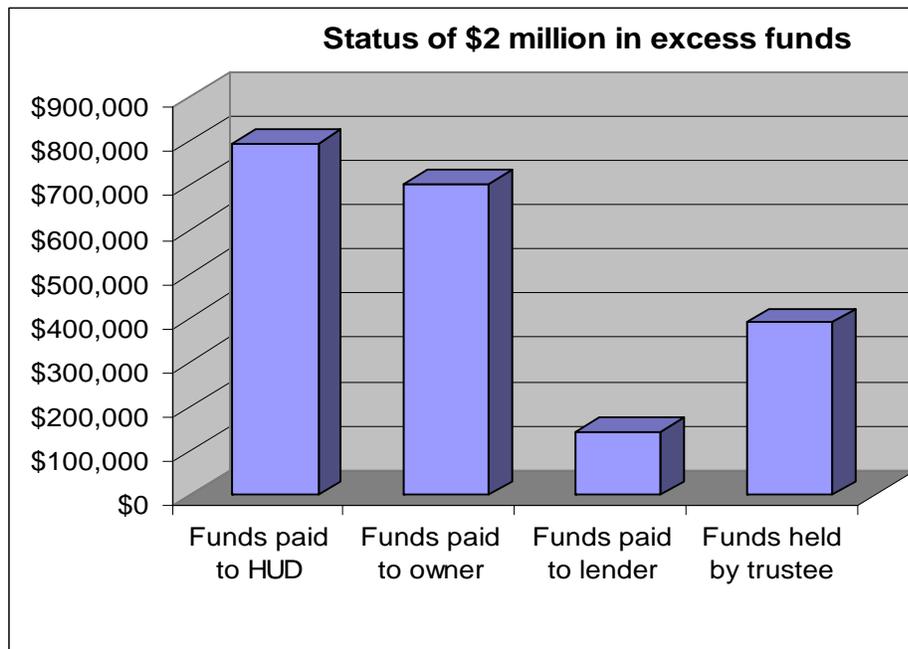
- Lenders to indicate whether the mortgage was bond financed;
- Staff to review trust indentures for all assigned projects identified as bond financed;
- Staff to contact trustees, identify the existence of excess funds, and determine their disposition;
- Staff to notify trustees of HUD's claim on any excess funds;
- Staff to track receipt of bond indentures and excess funds; and
- Staff to coordinate with other HUD divisions to collect excess funds.

HUD's Office of Housing should coordinate with the Office of General Counsel to establish legal precedents and procedures for claiming and collecting excess funds. On a project previously audited by OIG, Regional counsel in Region 7 prepared a letter, which contained legal arguments addressing HUD's claim on excess funds. The Director of Multifamily Housing used the letter, which contained the following legal arguments to successfully claim and collect excess funds:

- Federal Priority Statute, 31 U.S.C. § 3713(b),
- A project’s mortgage loan documents, and
- Principles of equity and fairness.

### Missed Opportunity to Collect

HUD cannot determine the total magnitude of excess funds because it has incomplete data. However, for the 33 bond-financed projects reviewed during this audit, HUD and OIG identified \$2 million in excess funds that had not been identified or claimed by HUD. HUD has recovered \$792,868 of these funds. The remaining funds, totaling \$1,237,450, that were paid to the owner, lender or still held by the trustee need to be claimed and collected by HUD (See Appendix C). The status of the total \$2 million in excess funds follows:



If HUD does not implement adequate controls over the origination and assignment of bond-financed projects, it will not claim and collect excess funds that may be generated by future assignments of bond-financed projects.

### HUD Has Started Taking Corrective Action

Since the start of our review, HUD has

- Revised the election to assign approval letter to require the lender to indicate whether the mortgage was bond financed,

- Begun obtaining and reviewing trust indentures for all assigned projects identified as bond financed,
- Requested another revision to the election to assign approval letter, clarifying when the trust indenture and the trustee statement of accounts are to be submitted,
- Amended the final settlement letter to emphasize that the trustee must submit the trustee statement and all excess funds, and
- Begun tracking the receipt of trust indentures and excess funds.

While this is a good start, HUD needs to further strengthen controls as represented by the following recommendations.

## Recommendations

We recommend that the assistant secretary for housing

- 1A. With the assistance of HUD's Office of General Counsel, identify ways to establish HUD's claim to funds remaining with a trustee after redemption of all outstanding bonds with HUD insurance benefits.
- 1B. Develop and implement procedures to identify all bond-financed projects.
- 1C. Pursue collection of the remaining balance of \$2 million in excess funds identified in appendix C.
- 1D. Develop and implement procedures to identify and claim excess funds.
- 1E. Develop and implement procedures to coordinate with other HUD offices to collect excess funds.

## SCOPE AND METHODOLOGY

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To accomplish our objectives, we reviewed the *United States Code, Code of Federal Regulations*, HUD handbooks, and processing guides. We also interviewed HUD personnel, reviewed individual trust indentures, and contacted trustees.

We identified 54 assigned bond-financed projects for audit using the following methodology:

- Querying HUD's three systems. We obtained a list of terminated mortgages from the F-47 system and joined it with data from the F-75 system and Real Estate Management System. Each of these systems has a field that identifies a project as being bond-financed. We queried these systems to identify bond-financed projects assigned between October 1, 2003, and August 31, 2006.
- Obtaining HUD's list. We obtained a listing of terminated bond-financed mortgages from HUD's Multifamily Claims Branch.
- Audit efforts. We selected a sample of 16 mortgages from the F-47 system based on the following constraints:
  - Initially endorsed between January 1, 1980, and January 1, 1988,
  - Original mortgage amount greater than \$2 million,
  - Interest rate less than 9.75 percent,
  - Termination date after October 1, 2003, and
  - Termination type "19" indicating the mortgage was assigned to HUD and a claim was paid.

We reviewed HUD program files and contacted lenders to determine whether there were indications of bond financing. In addition, we searched the Internet and found one lender whose Web site listed its bond-financed projects.

For these 54 projects, we requested trust indentures from the HUD Multifamily Claims Branch and from servicing lenders and issuers. We reviewed the trust indentures to determine the issuer of the bond, the trustee name, and the intended disposition of the final balances upon default. In a number of cases, the identity of the trustee had changed over time due to bank mergers. In these cases, we called the servicing mortgagees or searched the Internet to identify the trustee. When we found the trustee, we requested the amount and final disposition of any excess funds. Trustees for 21 projects did not provide the requested information. We accepted the final balance figures provided by 33 trustees who did provide information, but we did not verify the accuracy of the figures.

To achieve our audit objectives, we relied on computer-processed data contained in three different HUD databases. We assessed the reliability of these data and found them to be inadequate as they did not contain the entire bond-financed project universe. We were unable to identify the entire universe of bond-financed projects, and we will recommend that HUD improve its database to enable the tracking of all bond-financed projects.

We performed our audit work from July 2006 through January 2007 in the office of HUD-OIG in St. Louis and also at HUD headquarters in Washington, DC. Our audit period covered October 1, 2003, through August 31, 2006. We performed our review in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

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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.

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## Relevant Internal Controls

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

- Controls over identifying excess funds,
- Controls over claiming excess funds, and
- Controls over collecting excess funds.

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

HUD had inadequate controls over the origination and assignment of bond-financed projects to ensure that it identified, claimed and collected excess funds (see finding).

## APPENDIXES

### Appendix A

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

Recommendation number	Funds to be put to better use 1/
1C	\$1,988,066

- 1/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. This includes reductions in outlays, deobligation of funds, withdrawal of interest subsidy costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings which are specifically identified.

In this instance, the \$1,988,066 represents funds that were not collected or were paid to other parties and which should rightfully be returned to HUD's insurance fund. We are unable to estimate the amount of future savings that will occur by implementing our recommendations. The reported amounts do not reflect any offsetting costs.

## APPENDIX B

### SCHEDULE OF EXCESS FUNDS

	Project name	Project number	Excess funds identified	Mortgage amount	Assignment date
<b>Funds held by trustee</b>					
1	Lafon Home	064-57001	\$38,479	\$1,397,500	6-Jul-06
2	Cedars at the JCA	085-43073	\$264,655	\$55,100,000	9-May-06
3	Crystal Bay Apartments	118-11011	\$87,000	\$3,825,000	4-Oct-05
	<b>Subtotal</b>		<b>\$390,134</b>	<b>\$60,322,500</b>	
<b>Funds paid to HUD</b>					
1	Barkeley Gardens	012-35472	\$20,201	\$2,401,027	12-Jan-06
2	Gahanna Commons (A)	043-35363	\$83,956	\$4,907,600	13-Jun-05
3	Chatterton Club (A)	043-35364		\$4,203,900	13-Jun-05
4	Thurber Square (A)	043-35365		\$2,846,900	13-Jun-05
5	Monticello (A)	043-35366		\$3,712,700	13-Jun-05
6	The Savoy (A)	043-35367		\$4,451,000	13-Jun-05
7	Greenleaf-Greenbriar Apartments (A)	043-35368		\$6,478,600	10-Jun-05
8	Pinebrook Village Apartments	051-94004	\$231,595	\$3,733,385	1-Jun-06
9	Franklin Square	052-35397	\$263,216	\$3,240,500	31-Jan-06
10	Lakeland Wesley Village	083-35267	\$151,648	\$3,529,200	11-May-06
11	Tenderfoot Apartments (B)	101-35495	\$42,252	\$5,763,100	17-Dec-03
	<b>Subtotal</b>		<b>\$792,868</b>	<b>\$45,267,912</b>	
<b>Funds paid to lender</b>					
1	Vineyard Pointe	061-35513	\$52,012	\$5,778,900	31-Aug-06
2	South Lake Cove	061-35514	\$58,384	\$17,212,600	31-Aug-06
3	Sawatch Range Apartments	101-11107	\$33,760	\$4,310,600	27-Feb-04
4	Fountain Village	123-35341	\$36	\$18,791,700	19-Feb-03
	<b>Subtotal</b>		<b>\$144,192</b>	<b>\$46,093,800</b>	
<b>Funds paid to owner</b>					
1	Hudson Valley Care Center	014-22022	\$187,657	\$18,900,000	30-Jun-03
2	Briscoe House	023-43212	\$264,959	\$8,425,792	4-Feb-04
3	Haskell House	023-43231	\$32,272	\$11,700,000	4-Apr-03
4	The Willows on Clark Road Apartments	073-35532	\$32,028	\$5,085,000	11-Apr-06
5	Renaissance Apartments	075-35313	\$60,287	\$1,420,300	5-Apr-04
6	Champlin Shores	092-43071	\$101,917	\$13,981,300	7-Oct-04
7	Foothills Court (C)	123-11115	\$24,004	\$1,900,000	5-Jul-02
8	Windrose Village (C)	123-11116		\$2,901,300	3-Jul-02
9	Monterey Plaza (C)	123-11117		\$2,783,800	5-Jul-02
10	Paradise Village (C)	123-11118		\$1,572,500	3-Jul-02
11	Mission Place (C)	123-11119		\$1,530,000	1-Feb-02
12	Sahuaro West (C)	123-11120		\$1,497,100	10-Jul-02
	<b>Subtotal</b>		<b>\$703,124</b>	<b>\$71,697,092</b>	

	Project name	Project number	Excess funds identified	Mortgage amount	Assignment date
<b>No excess funds</b>					
1	Paragon Place	086-11038	\$0	\$5,962,400	3-Jun-04
2	Sequoia Village Apartments	086-11039	\$0	\$4,012,800	3-Jun-04
3	Necanicum Village Residential	126-43051	\$0	\$7,819,400	1-Feb-06
<b>Subtotal</b>				<b>\$17,794,600</b>	
<b>No information from trustee</b>					
1	Ennis Francis Houses	012-57235		\$16,794,100	1-Jun-04
2	Village Green	017-35080		\$346,000	21-Jul-04
3	Norton One Norton	017-35160		\$457,200	29-Aug-06
4	Green Meadows Apartments	033-35219		\$17,508,000	29-Oct-04
5	Green Meadows Apartments Phase II	033-35223		\$14,000,000	29-Oct-04
6	West Tech (D)	042-35478		\$14,690,000	2-Oct-06
7	Nansemond Square Apartments	051-35356		\$3,426,700	3-Aug-05
8	Hill Top North Apartments	051-94010		\$3,423,668	2-Dec-04
9	Poppleton Cooperative	052-35339		\$5,147,700	3-Nov-03
10	The Pavilion of Campbell Stone	061-43113		\$4,750,000	3-Dec-01
11	Madison Terrace	071-35441		\$5,056,300	10-Aug-05
12	El Paso Health Care Center	072-22020		\$4,589,300	25-Nov-02
13	Arlington Village	073-35574		\$3,742,500	24-Aug-06
14	Bolton Court	073-35575		\$2,054,100	24-Aug-06
15	Village Place	084-35263		\$634,100	15-Feb-05
16	Lucas Heights Phase III	085-35395		\$6,587,300	2-Sep-05
17	Grandview Heights Apartments	085-35399		\$1,792,900	26-Jul-04
18	Pennock Place Senior Housing	092-35622		\$11,505,000	22-Mar-05
19	Weatheredge Apartments	114-35445		\$7,851,500	16-Mar-05
20	Pleasant Valley Pines	121-35802		\$1,742,200	14-May-04
21	Bay Club	123-11130		\$16,650,000	18-Sep-03
<b>Subtotal</b>				<b>\$142,748,568</b>	
<b>Adjustment (B)</b>			-\$42,252	-\$5,763,100	
<b>54</b>	<b>Grand total</b>		<b>\$1,988,066</b>	<b>\$378,161,372</b>	

Footnotes:

- (A) Excess funds of \$83,956 were shared among the six projects.
- (B) Excess funds on Tenderfoot Apartments were collected prior to the start of our audit and adjustments were made to the chart.
- (C) Excess funds of \$24,004 were shared among the six projects.
- (D) The claim is not yet fully paid.