Management and Performance Challenges and Progress

In accordance with the Reports Consolidation Act of 2000, HUD's Annual Performance and Accountability Report "…shall include a statement prepared by the agency's inspector general that summarizes what the inspector general considers to be the most serious management and performance challenges facing the agency and briefly assesses the agency's progress in addressing those challenges." HUD's Acting Inspector General provided a statement on five management challenges for inclusion in this FY 2001 Performance and Accountability Report. HUD management agrees that the five areas identified in that statement are major challenges currently facing the Department. The full text of the HUD Office of Inspector General's FY 2001 Management and Performance Challenges statement is presented in its entirety, following the below management response on the current status of these challenges and future plans to address them.

Management Response to OIG Reported Management and Performance Challenges

HUD initiatives under the President's Management Agenda (PMA) are addressing each of the five major management and performance challenges reported by the OIG. The PMA consists of agency specific initiatives to address five interrelated government-wide goals pertaining to the strategic management of human resources, competitive sourcing of services, improved financial performance, expanded electronic government, and increased budget and performance integration. The HUD PMA initiatives pertaining to the five challenges identified by the OIG are as follows:

Challenge Areas 1 and 3: Complete Department-wide organizational changes and assure adequate and sufficiently trained HUD staff

These two challenges are being addressed under various initiatives under the PMA goals for the strategic management of human resources. HUD's June 1997 management reform plans were intended to realign the Department along functional lines, and to place greater reliance on automated tools and contracted services, to enable the Department to better utilize a reduced staffing capacity to more efficiently and effectively deliver and oversee major HUD program activities. Over the past 4 ½ years, the planned organizational and operational changes have been implemented to varying degrees, with some incremental progress and improvements realized. However, the majority of the organizational and process changes were never formally institutionalized and are still in need of delegations of authority and the issuance of current written policies and procedures to clarify organizational roles and responsibilities and provide a basis for staff training and operational consistency. Furthermore, some aspects of the organizational and staffing realignment have proven to be an ineffective use of HUD's scarce resources. Upon reexamination, decisions were made to:

- re-deploy staff in the Community Builder function to understaffed program delivery and oversight functions, where there is a more critical need,
- place processing center operations back under the control of HUD's traditional program and administrative components, to improve working relationships and strengthen accountability for resource use and results,

- loosen centralized control and empower field operating units to more effectively deal with local program issues, and

- formalize the revised organizational structure and provide current operating policies and procedures to support staff training and on-going operations.

To support these reorganization and redeployment decisions, and to provide on-going support for more effective resource management, the Department completed the implementation of the Resource Estimation and Allocation Process (REAP). REAP was used to assist in the development of HUD's FY 2002 staffing plan. The Office of Administration is in the process of identifying core competencies needed for each major career series and developing a strategy to keep critical positions filled. Also underway is the definition of career paths and appropriate training and development opportunities for major career series to support progression to professional positions within HUD.

To more effectively utilize HUD's limited staff resources and enhance HUD's monitoring of its third- party program delivery structure, a Compliance and Monitoring Training Program has trained over 1,230 field office staff in the past two years, on general management control practices and the use of risk-based monitoring techniques unique to specific HUD program areas. This training continues in FY 2002, along with the planned design and implementation of a Compliance and Monitoring Training effort directed at HUD supervisors and managers.

Challenge Area 2:
Improve Financial Management Systems

HUD's most significant financial management systems deficiencies exist in the Federal Housing Administration (FHA), where the FHA still needs to convert from its commercial accounting system to a system that fully supports the Federal basis of accounting and budgeting. HUD has purchased a commercial off-the-shelf software package for this purpose, and has established plans and procured the contract services necessary to implement the new FHA system. The phased implementation plan is on schedule to implement FHA's new core general ledger system in the fall of 2002. The core FHA general ledger system will provide automated uploads of data required to produce HUD's consolidated financial statements. FHA program systems will be integrated with the new FHA general ledger system over a multi-year period. Until these systemic solutions are fully implemented, compensating ad hoc processes and controls have been put in place by FHA to convert activities to the standard general ledger accounts, provide for the administrative control of funds, and comply with credit reform requirements. Maintaining these ad hoc processes will remain a challenge until the systemic solutions are in place to better support FHA's financial management operations.

Regarding HUD's core financial management system, the Office of the Chief Financial Officer has stabilized systems operations and demonstrated the ability to produce auditable consolidated financial statements for the last two years. The OIG's audit of HUD's FY 2001 consolidated financial statements reported two prior year reportable conditions as corrected, pertaining to the reliability and security of HUD's critical financial systems and controls over fund balance with Treasury reconciliations. Nevertheless, HUD's core financial management system and accounting operations would benefit from further enhancements and integration to provide more efficient operations and a reduced risk of error. In FY 2002, the OCFO is initiating a study of the feasibility and cost-benefit of various options for improving or replacing HUD's existing core financial management system.

On the subject of HUD's grants management systems, it is important to note that HUD has no high risk, material weakness or reportable condition issues associated with its grants management. However, there are opportunities for improvements in this systems area and HUD is working with the OMB's priority interagency e-Government initiative on e-Grants to determine the future direction of HUD's grants management systems efforts.

Regarding systems security issues, HUD appreciates the OIG's acknowledgment of improvements in the area of information security, and recognizes the need for further efforts and a continuous disciplined focus on security for all systems platforms and applications. At HUD, systems security is a shared responsibility of program systems sponsors, the Office of Administration and the Office of the Chief Information Officer. Efforts are underway to better train all parties on their respective areas of responsibility, and to provide the on-going discipline necessary to continuously fulfill those responsibilities. Systems security improvements are an area tracked under the President's Management Agenda, along with the above discussed FHA systems project and OCFO systems study.

Challenge Area 4: Improve FHA single-family origination and real estate owned property oversight

Most of FHA's single family housing mortgage insurance programs are user fee programs operating out of the Mutual Mortgage Insurance (MMI) Fund. FHA manages these programs in a manner that balances program risks with the furtherance of program goals, while maintaining the financial soundness of the MMI Fund. As discussed under Strategic Goal No. 1 of this report, the MMI Fund is financially sound and the single family housing programs are contributing to record homeownership rates, with a focus on homebuyers that are underserved by the conventional market. Nevertheless, overall program performance and the condition of the Fund could be further improved if all lenders, appraisers, property managers and other participants in FHA's program delivery structure fully adhered to FHA program requirements designed to reduce program risks and further program goals. Under the President's Management Agenda, FHA has a number of initiatives in process or under development to improve the content, oversight and enforcement of its program requirements, as well as the consideration of alternative business processes. Such actions include:

- Enhance qualifications for lender participation,
- A proposed rule to include measurement of lenders who underwrite in the Credit Watch Termination Program,
- Design of a risk-based targeting model for reviews of underwriting,
- A proposed rule to strengthen lender oversight of appraisers,
- A proposed rule on appraiser qualifications and the removal of appraisers from the FHA roster,
- Establishment of an Appraiser Watch system similar to Credit Watch for lenders,

- A proposed rule to restrict excessive fees and refinancings that do not benefit the borrower,
- A proposed rule to prohibit FHA insurance on housing resales within six months,
- Proposed rules on the removal of non-performing non-profits and 203(k) Program consultants from FHA rosters,
- Implementation of the Section 601 accelerated claims demonstration authority as a possible alternative to traditional FHA note servicing and property disposition activity related to notes and properties acquired through insured mortgage defaults and claims.

Challenge Area 5: Improve the effectiveness and efficiency of public and assisted housing program administration

As evidenced by this year's performance data, HUD's considerable efforts to improve the physical conditions at HUD-supported public and assisted housing projects are meeting with success. The percentage of HUD-supported housing units at projects that met or exceeded HUD's physical condition standards rose from 82 percent to 90 percent in the past year. HUD's oversight capability, and the related performance of the third party intermediaries that administer HUD's public and assisted housing programs on HUD's behalf, are expected to further improve upon the full implementation of the Public Housing Assessment System (PHAS) and Section Eight Management Assessment Program (SEMAP) rules, and the contracted services of the Performance-Based Contract Administrators assisting in the oversight of the Office of Housing's project-based assistance programs.

HUD recognizes the continuing material management control weaknesses associated with the tenant income, rent and subsidy determinations in its public and assisted housing programs. As previously discussed in the "Financial Management Accountability" section of this report, HUD has developed a comprehensive corrective action plan to strengthen management controls to reduce subsidy overpayments and better assure that program funds serve the right persons in the right amounts. Improving the performance of housing intermediaries and the reduction of subsidy overpayments are both areas that are tracked under the President's Management Agenda.

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FEB 26 2002

MEMORANDUM FOR: Mel Martinez, Secretary, S

David C. Williams

FROM: David C. Williams, Acting Inspector General, G

SUBJECT: Management and Performance Challenges

In accordance with Section 3 of the Reports Consolidation Act of 2000, the Office of Inspector General is submitting a statement to you summarizing our current assessment of the most serious management and performance challenges facing the Department of Housing and Urban Development (HUD) in fiscal year 2002 and beyond. These issues have been the focus of much of our audit and investigative effort. Our Semiannual Reports to the Congress provide more specific details.

As we reported last year, the management and performance challenges facing HUD have been present for many years. HUD is working to address these challenges and in some instances has made progress in correcting them. The Department's management challenges reported this year include the need to:

- ✓Complete Department-wide organizational changes.
- ✓Improve financial management systems.
- ✓Assure adequate and sufficiently trained HUD staff.
- ✓Improve Federal Housing Administration (FHA) single-family origination and real estate owned property oversight.
- ✓Improve the effectiveness and efficiency of public and assisted housing program administration.

The attachment provides a greater discussion of these challenges and the OIG's efforts to help the Department resolve these matters. It is important that HUD eliminate high risk and staff intensive programs, and assign sufficient resources to focus oversight on HUD's core mission areas.

HUD Management and Performance Challenges Fiscal Year 2002 and Beyond

Department-Wide Organizational Changes

During the previous HUD Administration, the Department underwent major organizational and management changes. The changes included the consolidation of common functions into centers, the establishment of Community Builders and a focus on enforcement. Many existing HUD employees were assigned new duties and responsibilities and many new employees were hired for hundreds of new positions. Sweeping changes were made to organizational lines of authority.

As HUD's new Administration came on-board last year, many of the organizational changes were still incomplete. Some of the changes created a pervasive tension between centralized control and local empowerment and it became evident to HUD's new management that some revised organizational changes were necessary. In this regard, efforts to realign HUD's field structure are being finalized. Other issues that need to be resolved are Real Estate Assessment Center physical inspection scores, the consolidation of all single family activities into just four Homeownership Centers (HOCS), and the continued need for a centralized enforcement operation.

Our audits and investigations have identified weaknesses brought about by delays in completing operational changes. For example, in September 2001, we testified before the House of Representatives Subcommittee on Oversight and Investigations of the Committee on Financial Services regarding the 1998 scandals of the Section 203(k) Rehabilitation Home Mortgage Insurance Program in New York City. We noted that the rapidity of the changes taking place in the single-family program during this period made HUD extremely vulnerable. Single-family staff was cut in half and those remaining in New York were transferred to the Philadelphia HOC. These staffing shifts had a direct bearing on HUD's ability to provide adequate oversight.

HUD's new management team is in the process of reexamining the changes brought about the previous administration and deciding what organizational realignments are needed to best address program needs.

Financial Management Systems

HUD needs to complete the development of adequate financial management systems. The lack of an integrated financial system in compliance with federal financial system requirements has been reported as a material weakness since fiscal year 1991. This noncompliance represents a material weakness in internal controls, and, while progress has been made in improving the Department's general ledger system (HUDCAPS), a number of long-standing deficiencies remain.

Our annual financial audits continue to report problems of inadequate systems integration. For example, there is a lack of an automated interface between the Departmental general ledger and the FHA subsidiary ledger, which necessitates extensive manual analyses, reprocessing, and additional entries. FHA's funds control process is also largely manual, even to the point of requiring the hand carrying of documents. Other serious deficiencies include the inability to timely identify excess funds on expired Section 8 projects and inadequate assurance about the propriety of Section 8 rental assistance payments. The systems solutions to these problems remain unresolved.

During the fiscal year 2001 Financial Statement Audit, we also noted another challenge for the Department in grants management. There are additional Joint Financial Management Improvement Program requirements for integrating certain transactions in the grants management systems with the core financial system. This has increased the importance of HUD's financial systems for consolidated financial reporting. However, the Department's efforts to implement the necessary grants management systems have made little progress to date.

To correct financial management deficiencies in a Department-wide manner, HUD initiated a project to design and implement an integrated financial system consisting of both financial and mixed systems. Over the years, the Department's plans have experienced significant schedule delays, changes in direction and cost overruns. Because of the many concerns we have raised in our audits, the Department is proceeding cautiously. The Department is planning to contract for a feasibility study and cost benefit and risk analyses to help it identify the best platform for its integrated financial system. In the meantime, the project to improve the FHA subsidiary accounting systems has made little progress because of necessary procurement delays.

HUD's security program and practices is another issue critical to HUD's financial systems. In accordance with the requirements of the Government Information Security Reform Act, the OIG performed its annual evaluation of HUD's security program and practices and found that the security monitoring program still needs strengthening, the information security program lacks executive level leadership and direction, and previously reported weaknesses in management, operational, and technical controls remain uncorrected. As a result, the absence of an effective entity-wide security program, proactive leadership from the Office of the Chief Information Officer (OCIO), and adequate management, operational, and technical controls may lead to insufficient protection of sensitive or critical resources and compromise the integrity, confidentiality, reliability, and availability of information maintained in HUD's systems.

HUD has a draft plan for establishing and maintaining an effective, comprehensive information technology security program at HUD. Our review found improvements in information security. Also, during fiscal year 2001, HUD initiated the planning and program development for an entity-wide security awareness and training program. Despite these improvements, the Department has still not placed adequate emphasis on information security.

Adequate and Sufficiently Trained Staff

HUD's fiscal year 1999 Annual Performance Plan noted that the Department no longer had a system for measuring work and reporting time, and that HUD lacked a single integrated system to support resource allocation. HUD worked with the National Academy of Public Administration (NAPA) to develop a methodology or approach for resource management that would allow the Department to identify and justify its resource requirements for effective and efficient program administration and management.

HUD needs to more effectively manage its limited staff resources. Many of the weaknesses facing HUD, particularly those concerning HUD's oversight of program recipients, are exacerbated by HUD's resource management shortcomings. Accordingly, we consider it critical for the Department to address these shortcomings through the successful completion of ongoing plans. To operate properly and hold individuals responsible for performance, HUD needs to know that it has the right number of staff with the proper skills.

We reported in prior years that HUD had not developed a comprehensive strategy to manage its resources. To address staffing imbalances and other human capital challenges, the Department has implemented the Resource Estimation and Allocation Process (REAP). The last phase of REAP (a baseline for staffing requirements) was completed in December 2001. The next step in development of the Department's resource management strategy is the implementation of the Total Estimation and Allocation Mechanism (TEAM). TEAM is the validation component of REAP and will collect actual workload accomplishments and staff usage data for comparison against the REAP baseline. TEAM is scheduled for implementation in the Spring of fiscal year 2002.

FHA Single Family Origination and Real Estate Owned (REO) Oversight

Procedures and practices pertaining to HUD's Single Family Loan Origination Program have undergone considerable change, particularly in the last 5 years. The changes have been both programmatic and organizational, including significant changes in loan underwriting requirements and the transfer of virtually all aspects of Single Family production and program monitoring from HUD staff to lenders and contractors under the oversight of HUD's Homeownership Centers.

A comprehensive audit of FHA loan origination practices two years ago found significant problems with FHA's reviews of lender underwriting and property appraisals. Also, the monitoring of lenders by the Quality Assurance Division was deficient. We noted problems with the oversight of pre-endorsement contractors, and the accuracy of information in the automated tracking system. These weaknesses increase HUD's risk of losses and can result in inflated appraisals, fraudulent underwriting, property flipping and other lending abuses. OIG audits and investigations continue to result in indictments and convictions in FHA fraud schemes. These fraudulent activities are occurring at the same time that FHA delinquencies are rising. HUD's procedures for monitoring both lenders and contractors were less than effective, resulting in an increased risk of fraud, waste and abuse.

More recently, we looked at the participation of not-for-profits in HUD Single Family Programs. The audit found that the Department was receiving little or no benefit from discounted sales of REO properties to not-for-profits. In many cases, not-for-profits were fronts for profit-motivated entities, or were unduly influenced by realtors, consultants, investors, contractors, and lenders that stood to profit from the discounted transaction. Discounted sales should have reduced the ultimate costs to low- and moderate-income homebuyers.

The audit of FHA's fiscal year 2001 financial statements includes a reportable condition on the need for improvement in early warning and loss prevention for FHA single family insured mortgages. FHA continues to make progress in improving its ability to monitor its insured portfolio. However, as of September 30, 2001, FHA had not yet fully implemented certain initiatives to effectively identify and manage risks in its single family insured portfolio. FHA needs to increase its use and analysis of other data now available to continue improvements in lender monitoring. Timely identification of lenders with above average early default rates is a key element of FHA's efforts to target monitoring and enforcement resources to single family insured mortgages and lenders that represent the greatest financial risks to FHA. Potentially problem lenders must be identified before FHA can institute loss mitigation techniques and lender enforcement measures that can reduce eventual claims.

FHA contracted for the management and marketing (M&M) of its Single Family properties in March of 1999. Seven companies received awards for the 16 M&M contracts to manage HUD's Single Family property inventory. The objective of the contracts was to reduce the inventory in a manner that: "(1) expands home ownership, (2) strengthens neighborhoods and communities, and (3) ensures a maximum return to the mortgage insurance fund." Our audits have shown that HUD needs to do more to strengthen its M&M contractor monitoring and follow-up procedures. We found performance deficiencies were not being corrected and HUD property conditions declined. HUD staffs were ill equipped to manage the voluminous amount of paperwork associated with M&M contractors. The audit of FHA's fiscal year 2001 financial statements concluded that the monitoring and performance of the M&M contractors tasked with managing and selling properties continues to need improvement.

Public and Assisted Housing Program Administration

HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofits and for profit) and Housing Authorities (HAs). These intermediaries, in-turn, provide housing assistance to benefit primarily low-income households. HUD spent about $21 billion in fiscal year 2001 to provide rent and operating subsidies that benefited over 4 million households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that these funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

The Office of Public and Indian Housing (PIH) provides funding for rent subsidies through its public housing operating subsidies and tenant-based Section 8 rental assistance programs. These programs are administered by HAs who are to provide housing to low-income families or make assistance payments to private owners who lease their rental units to assisted families.

The Office of Housing administers a variety of assisted housing programs including parts of the Section 8 program and the Section 202/811 programs. These subsidies are called "project-based" subsidies because they are tied to particular properties, therefore tenants who move from such properties may lose their rental assistance. This is a significant responsibility because of the sizable number of project owners HUD must monitor.

For many years we have reported on material weaknesses with the monitoring of HAs and multifamily projects. These monitoring weaknesses seriously impact HUD's ability to ensure that its intermediaries are correctly calculating housing subsidies. This material weakness was first reported in our financial audit in 1991 and it has been reported in every audit thereafter. The Secretary has made the reduction of subsidy overpayments a top priority of his Administration.

A recent study of rent determinations under housing assistance programs estimates that errors made by intermediaries result in substantial subsidy overpayments and underpayments. Using a statistical sample of tenant files, tenant interviews, and income verification data, the study concluded that projected subsidy overpayments of about $1.7 billion and underpayments of about $0.6 billion annually. Payment errors of this magnitude take on added significance in light of HUD's estimate of 4.9 million unassisted households that pay more than half of their income for housing or live in severely substandard housing.

We agree with HUD's initial efforts to address the incorrect rental subsidy determinations. HUD has undertaken initiatives such as (1) providing the housing authorities (HA) the information on the problems associated with rental subsidy determinations, (2) making available a guidebook on the requirements of housing choice voucher, and (3) conducting reviews of rental determinations during some on-site monitoring reviews. However, it will be another two years before all of HUD's planned corrective actions are implemented to fully address the problems. In addition, it may take several more years before the success of these actions will be known.

During fiscal year 2001, HUD continued to implement its performance oriented, risk based strategy for carrying out its HA oversight responsibilities. As noted in previous years, further improvements need to be made in the field offices' monitoring of its HAs in key areas. As in previous years, we could not fully assess HUD's measures aimed at improving oversight of HAs since the Department's plans to monitor and improve performance are not yet fully developed and continue to experience delays. Finally, HUD has been slow to implement additional strategies needed to improve the quality control over the rental assistance subsidy determinations. Nevertheless, we do believe that some of the initiatives are positive.

In prior years we have also reported on long-standing weaknesses with the processing of subsidy payment requests under the project-based programs administered by the Office of Housing. Historically, this process has been hampered by the need for improved information systems to eliminate manually intensive review procedures that HUD has been unable to adequately perform.

Office of Housing or Contract Administrator (CA) staff are to perform management reviews to monitor tenant eligibility and ensure accurate rents are charged at multifamily projects. The primary tool available to HUD is to conduct on-site reviews that assess the owners' compliance with HUD's occupancy requirements. HUD's continued implementation of the CA initiative resulted in a substantial increase in the total number of management reviews conducted during fiscal year 2001 compared with the previous year. However at the end of fiscal year 2001, reviews were performed at only a small portion of that part of the portfolio. A comprehensive plan needs to be developed that would result in an increase of on-site reviews that would assess and ensure that all owners of assisted multifamily projects comply with HUD's occupancy requirements.

HUD's plans include a variety of continuing efforts. Principle among these are: continued implementation of the CA initiative; increased enforcement efforts; implementation of more targeted risk management of reinspections of properties; better use of mortgagee inspectors; increased frequency of management/occupancy reviews for assisted projects; and development of an integrated risk reporting system.

We support the plans to increase the frequency of management/occupancy reviews for the assisted portfolio and suggest that similar to the approach to physical reinspections, they be performed more frequently for troubled and potentially troubled projects, and that occupancy review work be emphasized. We applaud HUD's efforts in implementing the Rental Housing Integrity Improvement Program and support the continued progress in addressing improper payments. Finally, we recommend the development of an integrated risk reporting system. This will enable the coordinated use of all monitoring tools that can be used throughout the year to successfully manage risk for insured and assisted projects.