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Office of Inspector General
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MEMORANDUM FOR: Steven Preston, Secretary, S

FROM: Kenneth M. Donohue, 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 (OIG) is submitting its annual statement to you summarizing our current assessment of the most serious management and performance challenges facing the U.S. Department of Housing and Urban Development (HUD) in fiscal year 2009 and beyond. Through our audits, investigations, and inspections and evaluations, we work with departmental managers in recommending actions that best address these challenges. More details on our efforts in relation to these issues can be found in our Semiannual Report to Congress.

The Department's primary mission is to increase homeownership, support community development and increase access to affordable housing free from discrimination. HUD seeks to accomplish this mission through a wide variety of housing and community development grant, subsidy, and loan programs. Additionally, HUD assists families in obtaining housing by providing Federal Housing Administration (FHA) mortgage insurance for single-family and multifamily properties. HUD relies upon numerous partners for the performance and integrity of a large number of diverse programs. Among these partners are hundreds of cities that manage HUD's Community Development Block Grant funds, hundreds of public housing agencies that manage assisted housing funds, thousands of HUD-approved lenders that originate and service FHA-insured loans, hundreds of Ginnie Mae mortgage-backed security issuers that provide mortgage capital, and other federal agencies with which HUD coordinates to accomplish its goals. HUD also has a substantial responsibility for administering disaster assistance programs. Currently, HUD is administering new mortgage assistance and grant programs in response to the nation's financial crisis, increase in foreclosures, and declining home values.

Achieving HUD's mission continues to be an ambitious challenge for its limited staff, given the agency's diverse programs, the thousands of intermediaries assisting the Department, and the millions of beneficiaries in its housing programs. In its January 2007 high risk update, the Government Accountability Office removed HUD's single-family mortgage insurance and rental housing assistance programs from its high risk list. Although HUD was removed from the high risk list, it needs to continue to place a high priority on efficient and effective management of these programs. Proposed and new program changes have introduced new risks and oversight and enforcement challenges. More specifically, HUD has implemented mortgage assistance for homeowners at risk of foreclosure through refinance options in its FHA-Secure and Hope for Homeowners programs. In addition, HUD has seen a dramatic increase in FHA-insured home equity conversion (also known as "reverse") mortgages. As a result, HUD will be challenged to develop adequate systems to account for these loans and help prevent fraud on this vulnerable population of seniors.

HUD's reported management challenges are addressed in the President's Management Agenda's government-wide and HUD-specific initiatives. As of the end of the third quarter of fiscal year 2008, HUD's President's Management Agenda scoring status for the nine applicable initiatives consisted of five "green," three "yellow," and one "red" baseline goal scores. Based upon a comprehensive set of standards, an agency is green if it meets all of the standards for success, yellow if it has achieved some but not all of the criteria, and red if it has even one serious flaw. It is noteworthy that HUD's human capital score has progressed from yellow to green; however, as noted in two OIG reports, HUD needs to improve existing procedures and controls regarding its succession planning and management of human capital. HUD's score for competitive sourcing declined to red during the third quarter of fiscal year 2007; however, during fiscal year 2008, the score increased from red to yellow.

HUD's baseline score for E-Government (E-Gov) declined from green to yellow during fiscal year 2008. HUD was downgraded from green to yellow because it did not remediate weaknesses in the agency's strategic plan and did not fulfill all E-Gov funding requirements. HUD's initiative to eliminate improper payments had declined from green to yellow because it was unable to achieve its reduction target by 0.5 percent. In the most recent scorecard, however, the score was raised back to green. HUD has been scored red on its credit management program since it was added to the President's Management Agenda in fiscal year 2006.

Although the management structure, size, and range of departmental programs make it difficult to correct and overcome program weaknesses, HUD is working to address these challenges. The Department's management challenges we are reporting this year include the following:

- HUD's response to the nation's financial crisis,
- Human capital management,
- Financial management systems,
- FHA single-family management,
- Public and assisted housing program administration, and
- Administering programs directed toward victims of natural disasters.

The attachment provides a greater discussion of these challenges and OIG's efforts to help the Department resolve these matters.

Attachment

HUD Management and Performance Challenges

Fiscal Year 2009 and Beyond

HUD's response to the nation's financial crisis. In view of the current credit and financial crisis impacting the nation, we are reporting a new management challenge to recognize the profound impact this will have on HUD. As we note later in our discussion of FHA's single-family program, HUD has already sustained significant losses in its single-family program, based on the results of the latest actuarial study, and is taking on additional risk. In response to increasing delinquencies and foreclosures brought about by the deteriorating subprime mortgage market, in September 2007, HUD acted administratively to provide mortgage assistance through the FHA Secure program to refinance existing conventional mortgages. This program was expanded in May 2008 to provide lenders the added flexibility to refinance and insure more mortgages, including those for borrowers who were late on a few payments and/or received a voluntary mortgage principal write-down from their lenders. The Housing and Economic Recovery Act of 2008 was enacted on July 30, 2008, and created a new Hope for Homeowners program to enable FHA to refinance the mortgages of at-risk borrowers provided that (1) mortgage holders write down the principal of the mortgages, (2) borrowers agree to share future equity with the federal government, and (3) borrowers can afford to repay their new loans. These programs are challenges for HUD to administer while minimizing risk to the FHA fund. The Congress authorized FHA to guarantee $300 billion in new loans to help prevent an estimated 400,000 homeowners from foreclosure.

The Housing and Economic Recovery Act of 2008 also created a new Neighborhood Stabilization Program. As part of this legislation, HUD must administer $3.92 billion in Community Development Block Grant funds to redevelop abandoned and foreclosed homes. In response to the state and local communities hard-hit by foreclosure, HUD was required to design the program and determine funding allocations within 60 days of enactment. Currently, there is no database that will provide HUD with sufficient data on units assisted, acquired, or disposed of. HUD must rely on the grantees to maintain this information at the local level. HUD is challenged to ensure, as Congress directed, that these grant funds are obligated for specific activities within 18 months and that state and local governments make the most effective use of available funds.

HUD needs to quickly hire more staff and upgrade its technology to be able to handle the huge increase expected in new business, but questions remain as to whether HUD will be given the resources it needs. In addition, we are concerned as to whether HUD has the necessary capacity or internal controls in place to assume the risks of the mortgage market being placed upon the agency. In creating the Hope for Homeowners program, the Housing and Economic Recovery Act of 2008 provided a mechanism, through the issuance of "HOPE bonds," to fund administrative costs for that program. HUD reports that funding for 22 staff positions and about $20 million in systems improvements have been made available in this manner. The Housing and Economic Recovery Act of 2008, however, did not provide for additional resources for other FHA modernization initiatives in the Act, nor did it provide HUD with additional resources to implement the Neighborhood Stabilization Program. FHA has had to reprogram other funds to address other FHA modernization needs. While the Congress subsequently appropriated $6.5

million that HUD may use for the Neighborhood Stabilization Program, part of that funding is also to be used for other unrelated disaster recovery activities.

Human capital management. For many years, one of the Department's major challenges has been to effectively manage its limited staff to accomplish its primary mission. To address its human capital needs and respond to the President's Management Agenda, HUD developed a comprehensive Five-Year Strategic Human Capital Management Plan that identifies three strategic goals for human capital:

- Becoming a "mission-focused agency," resulting in a more effectively deployed workforce;
- Maintaining a "high quality workforce," which recruits, develops, manages, and retains a diverse workforce; and
- Implementing "effective succession planning" to ensure that retirees over the next five years are succeeded by qualified employees.

To link HUD's human capital initiatives as presented in the Strategic Human Capital Management Plan, HUD has recently instituted a Human Capital Accountability System. In May 2006, to address the potential staff reduction due to retirement, HUD implemented a probability model to more accurately project future retirement and target high-risk critical positions for succession planning purposes. A 2007 OIG audit found that HUD had not fully initiated adequate succession planning to address future staffing concerns. Specifically, some HUD offices had failed to identify and/or support the actions needed to fully implement HUD's succession plan. HUD needs to ensure that all program offices initiate succession planning to comply with HUD's requirements.

HUD lacked a valid basis for assessing its human resource needs and allocating staff within program offices, as evidenced in OIG's 2008 audit pertaining to HUD's management of human resources. Three of the five offices we reviewed could not provide adequate documentation to support their assessment of human resource needs and allocation of staff among their headquarters and field office locations. As a result, HUD lacked assurance that its allocation of staff was based on supportable need and it accurately determined the human resources required to meet its performance goals. Some of HUD's program offices lacked adequate documentation to support their hiring practices. As a result, HUD lacked assurance that its program offices' hiring was appropriate.

Financial management systems. Since fiscal year 1991, OIG has annually reported on the lack of an integrated financial management system, including the need to enhance FHA's management controls over its portfolio of integrated insurance and financial systems. During the past several years, HUD has made progress by partially implementing new core financial systems at FHA and Ginnie Mae and addressing most of the previous weaknesses that OIG identified. These improvements enabled OIG to reclassify the weakness in financial management system requirements from a material weakness to a significant deficiency. However, the FHA home equity conversion mortgage systems were identified as a material weakness in the fiscal year 2007 FHA financial statement audit. The rapidly growing program was being supported by a combination of servicer-provided applications, vendor databases, modification of existing FHA legacy systems, and manually performed input to FHA's general ledger. FHA initiated a series of planned corrective actions during fiscal year 2008. These actions included performing a risk analysis of home equity conversion mortgage processing to identify accounting control risks. The risk analysis identified staff capacity as the primary vulnerability, and, reportedly, FHA is addressing this risk.

The HUD Integrated Financial Management Improvement Project (HIFMIP), launched in fiscal year 2003, has been plagued by delays, and implementation of the core financial system has not yet begun. Additionally, the HIFMIP project manager position has been vacant since February 2008. HIFMIP was intended to modernize HUD's financial management systems in accordance with a vision consistent with administration priorities, legislation, Office of Management and Budget directives, modern business practices, customer service, and technology. HIFMIP will encompass all of HUD's financial systems, including those supporting FHA and Ginnie Mae. HUD had intended to begin the implementation in fiscal year 2006. Due to delays with the procurement process, however, HUD anticipates that it will not be able to begin the implementation of its core financial system until fiscal year 2009. The success of the HIFMIP project continues to be at risk due to dated requirement documents, as well as the project manager vacancy. We continue to note the following weaknesses with HUD's financial management systems:

- HUD's ability to prepare financial statements and other financial information requires extensive compensating procedures.

- HUD has limited availability of information to assist management in effectively managing operations on an ongoing basis.

We continue to report weaknesses in internal controls and security regarding HUD's general data processing operations and specific applications. The effect of these weaknesses is that HUD cannot be reasonably assured that system information will remain confidential, safeguarded, and available to those who need it without interruption.

Another information technology systems concern is FHA's inability to fund systems development and to upgrade and replace legacy (developed in the 1970s and 1980s) application systems that had been previously scheduled to be integrated. Given the significant growth in FHA market share (from 16 to 36 percent during the year ending July 2008) that is expected to continue, FHA's system environment remains at risk.

As of June 30, 2008, HUD's E-Gov element on the President's scorecard has slipped from green to yellow status. In addition, as part of our annual information technology security review mandated by the Federal Information Security Management Act, we found that HUD has not completed all risk assessments for systems that are Web accessible and require some form of authentication (e.g., password).

FHA single-family management. FHA's single-family mortgage insurance programs enable millions of first-time borrower, minority, low-income, elderly, and other underserved households to realize the benefits of homeownership. HUD manages a rapidly growing portfolio of more than $450 billion in single-family insured mortgages. Effective management of this high-risk portfolio represents a continuing challenge for the Department. The President's Management Agenda has committed HUD to tackling long-standing management problems that expose FHA homebuyers to fraudulent practices. A key component of the Housing and Economic Recovery Act of 2008 is the FHA Modernization Act of 2008, which includes the following provisions:

- Increasing the minimum cash investment or downpayment for an FHA mortgage from 3.0 to 3.5 percent.
- Raising FHA loan limits in high-cost areas by setting the limit in such areas at 115 percent of the local area median home price, not to exceed a nationwide loan ceiling of $625,500 (150 percent of the conforming loan limit).
- Making several changes to FHA reverse mortgages by creating a higher, nationwide uniform loan limit, capping the maximum fee lenders can charge seniors for FHA reverse mortgages, establishing protections to prohibit requiring seniors to purchase other financial products in conjunction with FHA reverse mortgages, and authorizing reverse mortgages to be eligible for home purchase.
- Imposing a one-year moratorium on risk-based FHA insurance premiums.
- Eliminating seller-funded downpayment assistance.

While FHA did not participate directly in the subprime mortgage market, the collapse of that market and resultant decline in house prices has already had a significant impact on FHA's risk exposure. The recently completed actuarial review of FHA's Mutual Mortgage Insurance Fund estimates that the fund's economic value decreased from last year's $21.3 billion to $12.9 billion. This decline, coupled with a 29 percent increase in insurance in force, resulted in the fund's fiscal year 2008 capital ratio's decreasing from last year's 6.4 percent to 3.0 percent. The fund is mandated by law to maintain a capital ratio of at least 2.0 percent.

We continue to focus internal audit resources on the single family program. For example, we reported that HUD's Office of Single Family Housing had not fully implemented an internal control structure in accordance with Government Accountability Office internal control standards and HUD requirements. Specifically, it did not (1) perform a formal, systematic annual risk assessment of its programs and administrative functions, (2) plan and conduct ongoing management control reviews or alternative management control reviews of its programs, (3) establish an overall strategy regarding its risk-based monitoring of program activities and participants, or (4) identify corrective actions required to improve its management controls in a timely manner. Our internal audit of controls over the FHA appraiser roster indentified weaknesses in the quality control reviews and monitoring of the roster and in the retention of the initial application packages for all active appraisers on the roster. The roster contained unreliable data including the listing of 3,480 appraisers with expired licenses and 119 appraisers that had been state sanctioned. In another audit, we found that HUD's appraiser review process was not adequate to reliably and consistently identify and remedy deficiencies associated with appraisers. Additionally, HUD did not maintain information necessary to assess the effectiveness of its review process.

In support of HUD and the President's Management Agenda, OIG's strategic plan gives priority to detecting and preventing fraud in FHA mortgage lending through targeted audits and investigations. Our audits target lenders with high default rates. Our detailed testing focuses on mortgage loans that defaulted and resulted in FHA insurance losses. Results from these audits have noted significant lender underwriting deficiencies, prohibited late-endorsed loans, inadequate quality controls, and other operational irregularities. During fiscal year 2008, we completed 16 external audits of FHA-approved mortgage lenders as well as seven internal audits of single-family program activities. Judicial actions taken on Office of Investigation single-family-related cases included 261 indictments/informations. Recoveries on investigative cases totaled more than $45 million.

Public and assisted housing program administration. HUD provides housing assistance funds under various grant and subsidy programs to public housing agencies and multifamily project owners. These intermediaries, in turn, provide housing assistance to benefit primarily low-income households. HUD monitors these intermediaries' administration of the assisted housing programs.

HUD's Section 8 voucher program has evolved over the last four years as Congress passed legislation in the fiscal year 2005 appropriation bill that included budget-based funding for the Section 8 Housing Choice Voucher program. Under this methodology, public housing agencies receive an annual fixed amount of program funds. At year end, all excess funds are retained by the housing agencies, which account for the excess funds in a net restricted assets equity account but report to HUD on a quarterly basis. The excess program funds not used during the current year are eligible for program use in the next fiscal year, or if not used in subsequent fiscal years, the funds are reclassified as unusable but remain at the housing agencies. The challenges HUD faces in the monitoring of the Section 8 voucher program to ensure that housing agencies are fully utilizing public housing vouchers are evidenced in the June 30, 2008 indicators of public housing agency use of funds and voucher utilization rates, as follows:

- 2,335 public housing agencies participating in the Section 8 Program have accumulated $1.9 billion in excess funds since 2005, of which $1.4 billion is classified as unusable by HUD under the current program rules.
- The average voucher utilization rate for the 2,335 participating public housing agencies is 93.3 percent, which is less than the fiscal year 2004 rate of 98.5 percent achieved using the previous funding mechanism.
- 17 public housing agencies participating in the Moving to Work program have accumulated $1.8 billion in excess funds. Under the Moving to Work program, funds are expended in accordance with an agreement between HUD and each public housing agency.

While progress has been made, HUD continues to face challenges in establishing processes and systems for budgeting and funding Section 8 project-based contract renewals and amendments to meet program needs and ensuring appropriate funds control. Our work in fiscal year 2007 indicated that approximately $752 million in funding could have been recaptured.

HUD's ability to effectively monitor housing agencies and assisted multifamily projects continues to present challenges in achieving the intended statutory purposes of the housing assistance funds. These deficiencies have been reported for a number of years in OIG's annual audits of HUD's financial statements. HUD has made progress but needs to complete the implementation of the initiatives that address housing agencies' rental subsidy determinations, underreported income, and assistance billings. Although HUD has made substantial progress in taking steps to reduce erroneous payments, it must continue regular on-site and remote monitoring of the public housing agencies and project owners and use the results from the monitoring efforts to focus on corrective actions when needed.

Paralleling HUD efforts, our investigative and audit focus is concentrating on fraudulent practices and the lack of compliance with the Section 8 program statute and requirements. OIG conducted 34 external audits and two internal audits of the Section 8 Housing Choice Voucher program during fiscal year 2008. OIG also has professional appraisers on staff to assist in evaluating housing quality requirements as part of our audit efforts. In total, these external audits addressed whether housing agencies are correctly calculating subsidy amounts, correctly determining family income, complying with housing quality standards, fully using authorized vouchers, and implementing controls to prevent duplicative and fraudulent housing assistance payments. Our external audits identified questioned costs of $95 million and reported more than $40 million that could be put to better use.

Administering programs directed toward victims of natural disasters. Natural disasters continued to be a challenge for HUD in 2008. After spring floods in the Midwest and fires in California, the Gulf Coast was hit by two more major hurricanes, Gustav and Ike. Ike caused major home destruction in Texas along the Gulf Coast including Galveston and in the city of Houston. Gustav caused damage in Louisiana in and around New Orleans, as well as in the city of Baton Rouge. As result, HUD received more than $6.6 billion in emergency supplemental funding for rental assistance, the public housing capital fund, and the community development fund. As the disaster funds are awarded to various states, our OIG audit, investigative, and inspection staff resources will be assigned accordingly, since disaster funding is particularly vulnerable to waste, fraud, and abuse.

Due to unprecedented storm damage caused by hurricanes Katrina, Rita, and Wilma in 2005, HUD is overseeing approximately $20 billion provided in three separate supplemental disaster appropriations. For the period ending September 30, 2008, more than $10.5 billion has been disbursed for disaster recovery by the five Gulf Coast states: Alabama, Florida, Louisiana, Mississippi, and Texas. During the past year, we issued seven audit reports, resulting in findings of questioned costs of more than $20 million. In addition to the homeowner program, OIG has identified some other high-risk areas that will require continued oversight, including the following:

- Economic development (Small Business Loan Program),

- Texas Homeowner Program, and
- Gulf Coast regional infrastructure programs.

The Office of Investigation focused on disaster fraud regarding not only the Gulf Coast region hurricanes, but also the California wildfires and the Midwest region's floods. We continue to work with HUD to improve oversight and reduce program vulnerabilities. Current accountability concerns include (1) new disaster programs involving huge amounts of money, introduced with untested requirements and results, and (2) restrictions in using computer matching between HUD and other federal and local agencies. Such natural disasters will impact on HUD's resources and remain challenges into the future.