U.S. Department of Housing and Urban Development
Office of Inspector General
451 7th St., SW
Washington, DC 20410

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MEMORANDUM FOR: Shaun Donovan, 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 2010. Through our audits, investigations, 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 the 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 cities that manage HUD's Community Development Block Grant funds, public housing agencies that manage assisted housing funds, HUD-approved lenders that originate and service FHA-insured loans, Government National Morgtage Association 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. The continuing national credit and financial crisis is having a profound impact on HUD. Proposed and new program changes have introduced new risks and enforcement challenges. More specifically, Congress has funneled $13.6 billion of the American Recovery and Reinvestment Act through 11 of HUD's programs. The Act will increase the oversight responsibilities for the Department for the next three years. HUD is also a key to the nation's mortgage industry where the market share of FHA-insured mortgages has increased dramatically from 1.9 percent in 2006 to 27 percent as of July 31, 2009. The attachment discusses these and other challenges facing HUD.

Attachment

HUD Management and Performance Challenges
Fiscal Year 2010 and Beyond

Oversight of American Recovery and Reinvestment funds. Congress allocated $13.6 billion in funding to U.S. Department of Housing and Urban Development (HUD) programs under the American Recovery and Reinvestment Act of 2009 (Recovery Act). This allocation added significant funding to public and Indian housing capital funds, Community Development Block Grants, the Neighborhood Stabilization Program, homelessness prevention, and other HUD programs to modernize and "green" the public and assisted housing inventory, increase the low-income housing tax credit market, stabilize neighborhoods hit by foreclosures, and prevent homelessness. Carrying out the goals of the Recovery Act, managing the influx of mortgages and refinancing, and conducting its normal operations is a significant challenge.

Capacity issues of Recovery Act funding recipients will challenge HUD. For example, HUD decided to provide Recovery Act public housing capital funding to housing authorities it deemed "troubled." Currently, there are 174 troubled authorities which received allocations totaling $350 million in Recovery Act funds. HUD also waived certain contracting requirements for housing authorities receiving Recovery Act capital funds. In the instance of the troubled housing authorities, HUD believed the troubled authorities were those most in need of Recovery Act funds and stated that it would increase oversight of these authorities. Regarding the contracting changes, HUD noted that the Recovery Act directed it to assist the authorities to expedite and facilitate the use of the funds. The waivers are meant to help expedite the use of funds. Funding the troubled authorities and waiving certain contracting requirements increased the challenge to oversee the $4 billion in capital funds. The housing authorities must obligate the funds within one year of availability and spend those funds within the next three fiscal years.

The Recovery Act added $2 billion to the Neighborhood Stabilization Program that Congress created as part of the Housing and Economic Recovery Act of 2008. HUD administers the now nearly $6 billion program to redevelop abandoned and foreclosed homes. The Recovery Act set aside $50 million for technical assistance to improve the capacity of "neighborhood stabilization" communities to carry out the program. HUD plans to hire 32 people to oversee the hundreds of new grant applications and up to100 grants during the three-year life cycle of the Recovery Act funds. HUD will use the Disaster Recovery Grant Reporting system to collect information from the grantees. An Office of Inspector General (OIG) audit has determined that the system can collect the basic information that HUD needs to monitor the program. However, HUD needs to follow through and fully use the system to effectively target its monitoring efforts.

The Recovery Act added $3.5 billion to community planning and development funds for block grant activities and homelessness prevention; however, HUD must oversee the expenditure of these funds in the next three years.

In general, the Recovery Act directs HUD to ensure that (1) the $13.6 billion is awarded and distributed in a prompt, fair, and reasonable manner; (2) the recipients' use of funds is transparent to the public; (3) the funds are used for only authorized activities; (4) recipients avoid unnecessary delays and cost overruns; and (5) program goals are achieved, including specific program outcomes and improved results on broader economic indicators. This oversight role is and will be a challenge. Further, HUD must assist all of its recipients in reporting their use of funds on the Recovery Act Web site. HUD also has to ensure that the data the recipients report are accurate. This type of reporting is unprecedented.

During fiscal year 2009, we started and completed 31 audits and reviews of Recovery Act-related activities. These audits and reviews addressed the administrative capacity of selected Recovery Act grantees to meet their responsibilities to properly administer these funds. We also assessed HUD's efforts to date to assess the risks associated with Recovery Act funding along with the Department's plans to mitigate those risks. In addition, we completed three audits of two of HUD's systems that will be used to administer Recovery Act funds. Our 20 capacity reviews looked at grantees' administrative systems to determine whether the grantees are capable of effectively administering the large influx of Recovery Act funds. Fifteen of these reviews raised issues with the grantees' capacity.

Single-family programs. The Federal Housing Administration's (FHA) single-family mortgage insurance programs enable millions of first-time borrowers and minority, low-income, elderly, and other underserved households to realize the benefits of homeownership. HUD manages a rapidly growing portfolio of more than $650 billion in single-family insured mortgages. Effective management of this portfolio represents a continuing challenge for the Department.

HUD has sustained significant losses in its single-family program and is taking on additional risk. The number of FHA mortgages has risen dramatically. The increased mortgage traffic is accompanied by increases in defaults and restructuring. FHA's mutual mortgage insurance fund has fallen below the legally required 2 percent capitalization ratio. FHA's staffing has not increased in proportion to the increased activity, and FHA's information technology has not kept pace with the rapid rise in loan volume. The lack of modern integrated business and financial management systems greatly increases organizational and management staffing control risks. Office of Housing management contracted to assess capacity issues early in the current fiscal year. Short-term solutions to expand computer hardware capacity were recommended and, thus far, have enabled the single-family program to meet continued program growth. The long-term infrastructure solutions are proposed in a September 2009 strategic plan that will need dedicated appropriations to develop and implement modern FHA systems over the next few fiscal years. During this development period, FHA will need to compensate with additional staff or the use of service providers.

In May, Congress gave FHA additional loss mitigation authority to assist FHA mortgagors in implementing the Helping Families Save Their Homes Act. One new loss mitigation option is the FHA-Home Affordable Modification Program to provide homeowners in default a greater opportunity to reduce their mortgage payments to a sustainable level. The Act modifies the HOPE for Homeowners Program with the goal of helping additional families avoid mortgage foreclosure.

HUD faces many oversight challenges in working with its approved single-family lenders. In our May 2009 Inspections and Evaluation report, we noted that the Mortgagee Review Board's (Board) sanctions directly affected only a small number of FHA-approved lenders out of a possible 12,461 lenders. The violations for which the Board cited lenders rarely warranted withdrawal of FHA lending authority. The sanctions and fines obtained against lenders were frequently mitigated. Elapsed time to complete Board action was slow, taking an average of 6.4 months following notice to the lender, and was prolonged by case development or settlement negotiations in many instances. The Board's public visibility was also greatly reduced because the results of its rulings were not published in the Federal Register.

During fiscal year 2009, OIG testified or submitted a statement for the record at five congressional hearings covering FHA single-family mortgage issues. At those hearings, we raised several concerns including the declining health of the FHA fund, the possibility that subprime lenders could become FHA lenders, and increasing fraud in the reverse mortgage market. FHA plays a major role in supporting the housing market and resolving foreclosure matters at this critical juncture. In addition, the current degree of FHA predominance in the market is unparalleled. It is clear that the Department is committed to positioning FHA as rapidly as possible to deal with the changing dynamics. FHA has announced plans to implement a set of credit policy changes that will enhance the agency's risk management functions. Measures are also proposed to address fraudulent loans that can contribute to FHA's losses. However, we remain concerned regarding FHA's ability and capacity to meet its current requirements and services and to help avert an avalanche of new defaults. HUD faces challenges going forward to ensure that the FHA fund reserves are sufficient to cover future losses. Further programmatic adjustments may be needed to reduce the risk to the mutual mortgage insurance fund, or premium adjustments may be needed to ensure that the fund is self-sustaining. In addition, FHA will be challenged to hire sufficient and trained staff, modernize its fiscal and risk management information systems, and strengthen its underwriting practices.

We are also concerned that increases in demand on the FHA program are having collateral implications for the integrity of the Government National Mortgage Association (Ginnie Mae) mortgage-backed securities (MBS) program, including the potential for increases in fraud in that program. HUD needs to consider the downstream risks to investors and financial institutions of Ginnie Mae's eventual securitization of a large proportion of FHA's insured mortgages. Ginnie Mae securities are the only MBS to carry the full faith and credit guaranty of the United States. If an issuer fails to make the required pass-through payment of principal and interest to MBS investors, Ginnie Mae is required to assume responsibility for it. Typically, Ginnie Mae defaults the issuers and assumes control of the issuers' MBS pools. Like FHA, Ginnie Mae has seen an augmentation in its market share (it has in some recent months even surpassed both Fannie Mae and Freddie Mac) and guaranteed $418 billion in outstanding MBS during fiscal year 2009, nearly double any previous period. It also has stretched and limited resources for adequately addressing this increase.

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. HUD lacks a valid basis for assessing its human resource needs and allocating staff within program offices, as evidenced in OIG's September 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. In addition, HUD lacked assurance that its program offices' hiring was appropriate.

The Office of Administration supports the Department in areas such as strategic human capital management, skill gap training, management analysis, and human resource management. The Office of Administration's Director of Human Resources and its supporting Deputy position have had a history of frequent leadership changes, and were vacant for much of 2008. This situation contributed to OIG's determination that HUD's Office of Administration's internal controls over the processing of personnel actions were inadequate as evidenced in an April 2009 audit report. Consequently, HUD needs to ensure that the Office of Administration continues to be "mission-focused" and provides the leadership stability necessary for human resources accountability and success.

The new administration announced a "Human Capital Transformation," noting that the 2008 Federal Human Capital Survey ranked HUD 24th out of the 30 large agencies in the "Best Places to Work in the Federal Government" report. The HUD Secretary set a goal to hire talented staff through a streamlined process and to develop personnel to contribute to a workplace that advances HUD's mission of providing safe, affordable housing to every American while fostering a healthier work/life balance for all HUD employees.

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.

The contract to modernize HUD's financial management systems has not been awarded. 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. 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 is to 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 2010. 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.

FHA's business increased dramatically during fiscal year 2009, while the shortcomings of the current information technology (IT) systems and the lack of systems capabilities and automation in critical areas of the business are challenging FHA's ability to respond to changes in the market and implement needed changes to its business processes. The recent changes in the economy and the housing market and the explosive growth in FHA's single-family insurance program have exacerbated these issues and increased the need to move FHA IT modernization initiatives to the forefront. FHA's IT funding has not kept pace with business requirements, and no funding has been available for modernization. Critical maintenance has been deferred for the past four to five years, and old technology and fragmented architecture are inefficient and expensive to maintain. Congress appropriated $4 million for FHA IT modernization planning in fiscal year 2009. In

August, FHA completed the *IT Strategy and Improvement Plan*, which identifies FHA's priorities for IT transformation. The plan identifies 25 solution initiatives to address specific FHA lines of business needs. Initiatives are prioritized, with the top five being single-family related. The plan also calls for FHA to create a program management office to facilitate coordination and communication and track and report progress, provide support to managers, and support organizational change management activities. Its ultimate goal is to focus leadership effort and resources needed for a successful transformation initiative.

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.

As part of our annual IT security review mandated by the Federal Information Security Management Act, we found that HUD had not completed all requirements for the security certification and accreditation of its information systems or implemented an effective continuous monitoring program for security controls over its information systems.

Another IT concern is the ability to replace the antiquated infrastructure on which HUD and FHA applications reside in a timely manner. During 2009, HUD unsuccessfully attempted to move certain applications onto a modern platform. Workloads have dramatically increased and are processing on systems that are 15 to 30 years old, resulting in performance, flexibility, and interface issues. The use of aging hardware and software can result in poor performance and high maintenance costs. If the Office of the Chief Financial Officer and FHA IT infrastructure is not modernized, it will become increasingly difficult to maintain operations, make legislative system modifications, and develop or maintain required interfaces to other IT systems, leaving the system environment at risk.

Public and assisted housing program administration. HUD provides housing assistance funds under various grant and subsidy programs to multifamily project owners (both nonprofit and for profit) and public housing agencies. These intermediaries, in turn, provide housing assistance to benefit primarily low-income households.

The Office of Public and Indian Housing provides funding for rent subsidies through its public housing operating subsidies and tenant-based Section 8 rental assistance programs. These programs are administered by about 3,100 public housing agencies, which are to provide housing to low-income families or make assistance payments to private owners who lease their rental units to assisted families. In fiscal year 2009, the public housing authorities assisted 1.1 million low-income households.

Some public housing authorities reported shortfalls in voucher funding in 2009. Several factors contributed to shortfalls. First, the funding Congress provided to renew vouchers for calendar year 2009 was several hundred million dollars less than the amount for which agencies were eligible, based on their voucher use and costs during 2008. Second, tenant incomes declined—most likely due to recent job losses caused by the recession—driving up voucher costs in many regions of the country and worsening the financial crunch. The average cost of a voucher was more than 5 percent higher in the first quarter of 2009 than 12 months earlier, despite weakening in most rental housing markets.

The Office of Housing administers a variety of assisted housing programs including parts of the Section 8 program and the Sections 202 and 811 programs. The subsidies provided through these programs are called "project-based" subsidies because they are tied to particular properties; therefore, tenants who move from such properties may lose their rental assistance. For this fiscal year, HUD requested $8 billion for Section 8 project-based rental assistance.

HUD has made significant improvements in the area of erroneous payments. To reduce improper rental assistance payments, HUD's Office of Public and Indian Housing and Office of Housing worked with their housing industry partners and tenant advocacy groups to improve program guidance, training, and automated systems support. HUD developed and implemented the Enterprise Income Verification System—a Web-based, state-of-the-art system—to share income data in other federal databases with public housing authorities to improve their income verification process.

Administering programs directed toward victims of natural disasters. HUD is a designated primary agency for the long-term recovery of communities following a major disaster. As such, the Department continues to work with communities devastated by disasters, not only with the influx of federal dollars, but also with the technical expertise to put communities back together. As a result, approximately $27 billion has been appropriated for recent disasters including hurricanes, floods, and wildfires—$20 billion for Hurricanes Katrina, Rita, and Wilma and $7 billion for disasters occurring during 2008, principally Hurricane Ike. Of the funds provided to the five Gulf Coast states for the Hurricane Katrina disaster, $12.8 billion has been disbursed for the period ending September 30, 2009. Other states are working on their action plans.

As communities work to recover from recent disasters, others are still struggling from the effects of Hurricane Katrina. To illustrate this slow process, Congress recently passed the Supplemental Appropriations Act for Fiscal Year 2009 (Public Law 111-32, enacted June 24, 2009). The Act provides an additional $80 million for the Housing Choice Voucher program to provide additional temporary housing for areas impacted by Hurricanes Katrina and Rita. As the disaster funds are awarded, our audit and investigative work continues to serve as a deterrent to fraud, waste, and abuse in these most vulnerable programs.

As a result of our audit efforts, the management challenges that HUD faces in administering the distribution of disaster funds is a delicate balance of speed of fund distribution versus the need for accountability and controls. Our work in fiscal year 2009 further demonstrated the following ongoing management challenges:

- Balancing of internal controls versus the timely distribution of funds
- Up-front program design performed to ensure that major program risks are identified (i.e., homeowner insurance requirement)
- Prevention of the duplication of benefits from the many federal disaster programs

In a recent audit of the State of Texas, we reported that more than $60 million in recovery funds was at risk because program design did not allow for the inclusion of an ongoing homeowner insurance requirement. The State's action plan did not allow for a provision for a period equitable to the amount of funds invested or prohibit the homeowner from being able to receive future disaster recovery funds.