U.S. Department of Housing and Urban Development
Office of Inspector General
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MEMORANDUM FOR: Alphonso Jackson, 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 Department of Housing and Urban Development (HUD) in fiscal year (FY) 2008 and beyond. Through our audits and investigations, 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 audit and investigative chapters of our Semiannual Report to the Congress.

The Department's primary mission is to expand housing opportunities for American families seeking to better their quality of life. 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 (CDBG) funds, hundreds of public housing authorities 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 in the Gulf Coast region.

Achieving HUD's mission continues to be an ambitious challenge for its limited staff, given the agency's diverse mission, the thousands of program intermediaries assisting the Department in this mission, and the millions of beneficiaries in its housing programs. HUD's management problems had for years kept it on the Government Accountability Office's (GAO) list of agencies with high-risk programs. In its January 2007 high risk update, GAO removed HUD's single-family mortgage insurance and rental housing assistance programs from its high risk list. Although HUD was removed from the GAO high risk list, it needs to continue to place a high priority on efficient and effective management of these programs. Proposed program changes could introduce new risks and oversight challenges. More specifically, HUD has proposed changes to its single-family mortgage insurance program that would increase the size of the mortgages HUD could insure, give HUD flexibility to set insurance premiums based on the credit risk of borrowers, and reduce downpayment requirements from the current 3 percent to potentially zero. 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 those loans.

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 FY 2007, HUD's President's Management Agenda scoring status for the nine applicable initiatives consisted of five "green," two "yellow," and two "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 of a number of serious flaws. It is noteworthy that for the first time since the President's Management Agenda was announced in August 2001, HUD received a green status rating for Improved Financial Performance in the second quarter of FY 2007.

HUD's baseline score for competitive sourcing status declined from yellow in the second quarter to red in the third quarter of FY 2007. Competitive sourcing is a process that compares private-sector and government bids to determine the most cost-effective way to buy services. HUD was downgraded from yellow to red because it did not implement a competition after it was completed and also did not notify OMB of the final disposition of the competition in a timely manner. HUD plans to streamline competitions to elevate its rating. HUD has been scored red on its credit management program since it was added to the President's Management Agenda in FY 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 and, as shown by the President's Management Agenda scoring, has made progress. The Department's management challenges we are reporting this year include the following:

- Human capital management,
- Financial management systems,
- FHA single-family origination,
- Public and assisted housing program administration, and
- Administering programs directed toward victims of Hurricanes Katrina, Rita, and Wilma.

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 2008 and Beyond

Human Capital Management. For many years, one of the Department's major challenges has been to effectively manage its limited staff resources to accomplish its primary mission. In addition to having limited staff resources, approximately 60 percent of HUD's workforce will be eligible to retire by fiscal year (FY) 2009.

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:

- Mission-focused agency to align employees and work to support HUD's mission;
- High quality workforce, which recruits, develops, manages, and retains a diverse workforce; and
- Effective succession planning to ensure that retirees over the next five years are succeeded by qualified employees.

To address staffing imbalances and other human capital challenges, the Department seeks to determine its optimal organizational structure and reduce mission-critical skill gaps to ensure that it is positioned to provide maximum service to its constituents. The Department is also proceeding to develop a vision for the future to address what its work will be, how it should be organized to carry out the work, and the required skills in relation to full-time employees and training efforts. HUD continued to implement its Five-Year (FY 2003-2008) Strategic Human Capital Management Plan, enabling it to recruit, develop, manage, and retain a high-performance workforce that is capable of effectively supporting HUD's mission.

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 in May 2006. A recent Office of Inspector General (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 taken to fully implement HUD's succession plan. To ensure that adequate succession planning is in place, HUD needs to implement adequate procedures and controls to ensure that all program offices initiate succession planning to comply with HUD's requirements.

Competitive sourcing is a government-wide initiative designed to ensure that the government acquires commercially available services at the best value for the taxpayer, regardless of whether such services are provided by the private sector or federal government. The Department is committed to using competitive sourcing as a means of achieving efficiencies, increasing cost effectiveness, and improving services, while minimizing program risks. HUD is challenged with carefully balancing the impact of outsourcing on program risk.

As evidenced in OIG's recent audit of HUD's contract administration process, as HUD contracts out for more services, it is challenged to provide adequate in-house staff to monitor those contracts. OIG found that HUD did not have adequate controls over processes to ensure (1) quality of statements of work, (2) the continued need for goods and services, (3) support for payments to contractors, and (4) proper evaluation and reporting of contractor performance. OIG audits of HUD's oversight of contractors' marketing of real estate-owned properties and HUD's oversight of project-based Section 8 contract administrators have resulted in findings that oversight shortcomings have adversely impacted contractor performance.

Financial Management Systems. Since FY 1991, OIG has annually reported on the lack of an integrated financial system in compliance with all federal financial management system requirements, including the need to enhance the Federal Housing Administration's (FHA) management controls over its portfolio of integrated insurance and financial systems. During the past several years, HUD has made progress in implementing a new financial system at FHA and addressing most of the weaknesses that OIG identified. These improvements enabled OIG to reclassify the weakness in financial management system requirements from a material weakness to a reportable condition. Other weaknesses noted were as follows:

- FHA needs to continue progress in integrating its financial management systems.
- FHA needs to improve its compliance with HUD and federal information system security requirements.
- 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.

For the past several years, OIG's financial audits have also reported weaknesses in internal controls and security over 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, protected from loss, and available to those who need it without interruption.

FHA Single-Family Origination. FHA's single-family mortgage insurance programs enable millions of first-time, minority, low-income, elderly, and other underserved households to realize the benefits of homeownership. HUD manages about $340 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. HUD has, however, proposed changes to its single-family mortgage insurance program that could introduce new risks and oversight challenges. Specifically, HUD's proposed changes and challenges include the following:

- Creating a new, risk-based insurance premium structure for FHA that would match the premium amount with the credit profile of the borrower. OIG is concerned that this structure could expose the insurance program to fair housing questions and accusations of "redlining" unless the decision matrix for pricing is unimpeachably objective.

- Eliminating the current statutory 3 percent minimum downpayment, reducing a significant barrier to homeownership. HUD has to address concerns that lowering the minimum downpayment could increase default risks.

- Increasing and simplifying FHA's loan limits. OIG is concerned that raising FHA area loan limits, especially in high-cost areas, will not help low- and moderate-income families become homeowners and will expose the insurance fund to increased risk from regional economic downturns.

In addition to proposed reform, HUD has taken a number of recent actions to reduce risks including the following:

- At our urging and in light of an Internal Revenue Service ruling regarding nonprofits that provide seller-funded downpayment assistance, HUD published a final rule that will prohibit downpayment gifts, when the gift was derived either directly or indirectly from the seller.

- HUD incorporated better risk factors and monitoring tools into FHA's single-family insured mortgage program risk analysis and liability estimation process, and

- HUD continues to improve its review of the credit reform estimation process.

We continue to focus internal audit resources on the single-family program. For example, our audit of the Title II manufactured housing loan program found that more than 80 percent of FHA Title II insured manufactured housing loans that closed from 2003 through 2005 were installed on substandard foundations. As a result, FHA's insurance fund is not adequately protected, homeowner equity and resale values are diminished, and the structural integrity and safety of the homes are questionable. We recommended that HUD correct program weaknesses to ensure that Title II manufactured housing foundations meet FHA requirements and avoid unnecessary losses to the insurance fund.

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 FY 2007, we completed 12 external audits of FHA-approved mortgage lenders as well as five internal audits of single-family program activities. We identified questioned costs of $2.2 million and funds that could be put to better use totaling $47.5 million. During FY 2007, judicial actions taken on Office of Investigation single-family related cases included 232 indictments/informations.

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.

The project-based Section 8 program has evolved over the years, and, accordingly, the services required from the contractors to administer the program have changed. However, our audits have shown that the terms of the contracts between HUD and the contractors have not been modified as the program service needs have changed. In addition, HUD faces 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.

Accurate and timely information about households participating in HUD housing programs is necessary to enable HUD to monitor the effectiveness of the program, assess agency compliance with regulations, and analyze the impacts of proposed program changes. The level of reporting is a criterion for housing agencies' performance in both the Public Housing Assessment System and the Section 8 Management Assessment Program. HUD's goal is to obtain a minimum of 95 percent reporting of tenant data into the system.

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. However, HUD has continued to make progress in this area by implementing several initiatives that address the problems surrounding housing authorities' rental subsidy determinations, underreported income, and assistance billings. This progress assisted the Department in being removed from GAO's high risk list.

The estimate of erroneous payments that HUD reports in its performance and accountability report relates to its inability to ensure or verify the accuracy of subsidy payments being determined and paid to assisted households. The baseline estimate of gross annual improper payments was reduced from $3.2 billion in 2000 to $1.2 billion in the 2004 study, a 62 percent reduction. However, the estimate did increase slightly to $1.5 billion in the 2005 study. The $1.5 billion consisted of rent determination errors made by the intermediaries to whom HUD incorrectly paid $925 million in annual housing subsidies, $338 million in housing subsidy overpayments caused by tenants' misreporting their income, and an error estimate of $206 million for billing errors. Although HUD has made substantial progress in reducing 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 30 external audits and two internal audits of the Section 8 Housing Choice Voucher program during FY 2007. 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 audits identified questioned costs of more than $13.7 million and reported more than $80.8 million that could be put to better use.

Administering Programs Directed Toward Victims of Hurricanes Katrina, Rita, and Wilma. In the aftermath of Hurricanes Katrina, Rita, and Wilma, the operations of HUD have been thoroughly tested in the Gulf Coast area and have created extraordinary challenges for the residents, HUD employees, and the business community. The losses to HUD and its housing and community development programs are significant and continue to be a focus and challenge for HUD OIG. To deal with the enormous task of enforcement and oversight, OIG has established a new regional office, headquartered in New Orleans, Louisiana. OIG audit, investigative, and inspections staff provide a continuing and comprehensive review of the expenditure of funds and their administration.

Regarding the accountability and oversight of the approximately $17 billion in supplemental disaster funding, we have identified some specific program areas that will need immediate attention during this period due to high risk, potential substantial additional funding requests, and high profile special assistance requirements. These areas include the following:

- Community Development Block Grant funding for Louisiana's Road Home program,
- The Disaster Housing Assistance Program, and
- Disaster funds to assist public housing agencies in the Gulf Coast region.

HUD OIG has concerns about the accountability and oversight of HUD-funded programs in the Gulf Coast region because of (1) substantial potential additional funding requests for Road Home applicants, (2) high profile special assistance requirements for the Disaster Housing Assistance Program, and (3) risks associated with possible duplication and inappropriate uses of funding sources for the repair and reconstruction of public housing units.

There are also continuing problems with the execution of data matching among federal agencies. It took months for OIG to finalize a protocol with the Federal Emergency Management Agency to use its data for matching purposes to detect potentially fraudulent payments. The problems that we have encountered would be greatly mitigated if the Privacy Act included an exception for post disaster data matching or if alternative legislation required federal agencies to engage in data matching as a routine procedure in their provision of disaster assistance.