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COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

B-153449

April 6, 1978

The Honorable Charles H. Percy
The Honorable ~~Adlai~~ Stevenson
United States Senate
The Honorable Paul Simon
House of Representatives

In response to your November 8, 1977, request, we reviewed the loan management procedures used by the Department of Housing and Urban Development (HUD) and the Department of Commerce's Economic Development Administration (EDA) to monitor the repayment of loans provided to the Rend Lake Conservancy District (Benton, Illinois) for construction of a water transmission system and treatment facility. You were particularly concerned about the long time that elapsed before HUD negotiated a new repayment plan for the delinquent interest and principal on its loan to the district. We found that:

--HUD and EDA had not managed the district's loans adequately; contrary to their procedures, they had not taken timely action when adverse trends were identified and when the loans became delinquent.

--HUD took an inordinate amount of time to work out a solution for the repayment of delinquent interest.

--EDA had not approved a plan for the repayment of delinquent interest as of February 1978.

Our review was made at HUD and EDA central offices in Washington, D.C. We analyzed HUD and EDA loan management procedures and documents and data pertinent to the loans made to the district. We also interviewed HUD and EDA officials responsible for administering public facility loans.

We are making recommendations to the Secretaries of HUD and Commerce to improve their management of public facility loans. (See p. 8.) As you requested, we did not obtain written agency comments on our findings. However, we did

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discuss them with HUD and EDA officials and have included their comments in our report. (See p. 8.)

PUBLIC FACILITY LOANS

The Housing and Home Finance Agency (predecessor to HUD) public facility loan program was authorized by title II of the Housing Amendments of 1955 (42 U.S.C. 1491). The Area Redevelopment Administration (predecessor to EDA) public facility loan program was authorized by the Area Redevelopment Act, which was enacted May 1, 1961, and terminated on August 31, 1965. Subsequently, the Public Works and Economic Development Act of 1965 (42 U.S.C. 3121 et seq.) authorized EDA to make public facility loans.

Although the loans to the district were made by the predecessor agencies, we will use HUD and EDA in our report.

Public facility loans made by HUD and EDA are used to help purchase or develop land and improve public works, public services, or facilities. One goal of the loan programs is to create job opportunities for unemployed or underemployed persons living in the project area. Water and sewer facilities, hospitals, and recreational facilities are examples of public facility projects. Communities unable to obtain financing in the open market at reasonable terms and conditions are primary recipients of public facility loans.

Other assistance programs began replacing public facility loans in 1973. The Housing and Community Development Act of 1974 (42 U.S.C. 5301 et seq.) consolidated several categorical programs, including the public facility loan program, into one block grant program. The number of public facility loans made by EDA dropped from 26 in fiscal year 1973 to 0 in fiscal year 1977. EDA is continuing to provide public facility grants to economically distressed areas.

As of September 30, 1977, HUD and EDA had a combined total of 1,954 outstanding public facility loans amounting to $651 million. The following table shows the number and dollar amounts of loans held by each agency as well as the number of loans and corresponding dollar amounts in arrears.

Status of HUD and EDA Public Facility Loans

as of September 30, 1977

Agency	Number of loans	Loans in arrears	Percent of total	Amount of loans	Principal and interest in arrears
				(000 omitted)	
HUD	1,544	64	4.2	$475,970	$ 7,166
EDA	410	70	17.1	175,019	10,773
Total	1,954	134	6.9	$650,989	$17,939

REND LAKE CONSERVANCY DISTRICT

In June 1965 HUD and EDA loaned the district about $12.4 million for the construction of a water treatment plant and a 125-mile network to supply water to 13 principal and 24 satellite communities in southern Illinois. The project was initially financed by two series of bonds--revenue bonds in the amount of $8 million financed under HUD's public facility loan program and revenue bonds in the amount of about $4.4 million financed under EDA's public facility loan program.

Subsequent overruns in construction costs required additional funds, which were made available as follows.

	Loans HUD	Loans EDA	EDA grant	Total
Loans approved 6/65	$8,000,000	$4,383,000	$ -	$12,383,000
Additional financing:				
Loans approved 3/68	775,000	342,000	-	1,117,000
Loans approved 4/71	150,000	-	-	150,000
EDA grant	-	-	80,000	80,000
Total Government financing	$8,925,000	$4,725,000	$80,000	$13,730,000

Because these were revenue bonds, interest and principal were payable only from revenue derived from operation of the water system. Such revenue must first be used to pay operation and maintenance expenses and then to establish reserves for depreciation before any can be applied toward the debt service. Interest was due semiannually and the principal was due at the maturity of the bonds.

During late 1965 and early 1966, the district contracted with 12 communities for the purchase of water. Those communities agreed to purchase all their water from the district at stipulated rates for 40 years. The 40-year period was to start when the district accepted the completed facilities. In addition, the contract provided that rates charged for water would be reviewed every 5 years and raised only to the extent required to meet the district's debt service and financial obligations.

The district's loans became delinquent in May 1971, just about the time its water system became operational. From May 1971 to January 31, 1978, the district had made only three partial interest payments to HUD and had made no payments to EDA. As of December 31, 1977, the district owed interest in arrears of $2,259,937 to HUD and $1,150,537 to EDA.

REND LAKE LOANS INADEQUATELY MANAGED BY HUD AND EDA

Our review showed that HUD and EDA, contrary to their procedures, did not take timely action to forestall default when adverse trends were identified and when their loans to the district became delinquent. They knew as early as November 1969 that the district was projecting a deficit operation. Subsequently, the district's loans went into default in May 1971. When a loan becomes delinquent, the agencies are required to establish alternatives, such as refinancing and loan consolidation, to remove the loan's delinquent status. HUD took an inordinate amount of time to work out a solution for the repayment of delinquent interest. It was not until September 1977, more than 6 years after the loan became delinquent, that it negotiated a new repayment plan. At September 1977 the HUD loan was in arrears about $2 million. Moreover, at February 1978 EDA had taken no action to remove the delinquency on its loan.

Untimely action by HUD

The legislation for public facility loans says that all loans made shall be of such sound value or so secured as to reasonably assure retirement or repayment. HUD guidelines state that (1) the basic security for each loan is generally a pledge of project revenues and (2) loan security must be sufficient to reasonably assure repayment.

HUD's loan management procedures provide for examining loans to (1) identify adverse trends in performance so that timely action may be taken to forestall default and (2) establish alternatives for delinquent or marginal loans through refinancing and loan consolidation.

In June 1965 HUD agreed to loan the district $8 million if it met a number of conditions to assure the production of revenues required for the payment and security of principal and interest. One of these was to obtain written contracts from its potential customers.

To meet this condition the district contracted, between October 1965 and January 1966, with 12 communities in southern Illinois for the purchase of water. These contracts provided for the water rates to be reviewed every 5 years from the date of the contracts. Unless the district and the communities intended otherwise, it appears to us that a literal interpretation of the contract would have permitted the district to have reviewed the water rates beginning in October 1970. On the basis of that review the rates could have been increased so the district could meet its debt service and other financial obligations. The district further agreed to fix and maintain sufficient rates to pay the cost of operations and the principal and interest on all outstanding revenue bonds.

According to a HUD quarterly loan management report, it was aware as early as November 1969--about 18 months before the district began operations--that the district, in its October 1969 Treasurer's report, had projected a deficit operation through November 1974. In April 1971--1 month before the district began operation--the district again told HUD that it would not have funds to pay the interest for the next 2 years. Although the contracts provided for increasing water rates and the district agreed to charge rates high enough to pay the cost of operations and the principal and interest on the loans, HUD did not request the district to do so. Therefore, the loan became delinquent. HUD officials stated that the district would have had to raise its water rates to meet its financial obligations, but this was impossible until

May 1976 because HUD interpreted the contracts between the district and its customers as preventing an increase in rates for the first 5 years of operation. However, as discussed on page 5, we are of the opinion that the contracts allowed raising the water rates beginning in October 1970, by an amount sufficient to cover the debt service on the loan before the district began operations.

Inordinate amount of time taken to work out a solution for delinquent interest

After the loan became delinquent in May 1971, HUD took an inordinate amount of time to work out a solution for the repayment of delinquent interest. HUD's first documented attempt to obtain delinquent interest was during a visit in October 1975, when delinquent interest amounted to $1.4 million. The district agreed to make an interest payment of $50,000 as a result of another HUD visit in December 1975. In February 1977 HUD again visited the project to obtain another interest payment but was unsuccessful. It was not until June 1977 that HUD told the district to either submit an acceptable repayment plan within 60 days and commence regular payments or it would refer the account to the Department of Justice for legal action. Consequently, the district submitted a repayment plan in August 1977 and increased the water rates in September 1977. HUD accepted the repayment plan in September 1977 which provided for repaying delinquent interest and retiring the loan within the stated term.

Although HUD identified the adverse trends in performance, it did not take timely action to resolve the problem. We believe that in November 1969, when HUD first became aware of the district's projected deficit, it should have requested the district to raise its water rates, beginning in October 1970, to cover the cost of operations and financial obligations to the Government.

UNTIMELY ACTION BY EDA

EDA is authorized to make public facility loans after determining, among other things, that there is a reasonable expectation of repayment.

According to EDA's procedures it is responsible for

--identifying loans with adverse trends which might adversely affect the security held by the Government and taking appropriate action to forestall default;

--managing public works loans and, if they become delinquent, acting to remedy the delinquency;

--recasting delinquent loans if a financial analysis indicates that a moratorium is necessary to protect EDA's interest; and

--safeguarding loans receivable and expediting collection procedures. EDA's procedures also provide for visiting delinquent projects at least once a year to secure necessary actions to correct the delinquency.

In June 1965 EDA agreed to loan the district $4.4 million if it assured the repayment of principal and interest. As discussed on page 5, the district's water rate contracts provided for rate increases to meet its debt service. The district also agreed to charge rates sufficient to pay the principal and interest on the outstanding loan. EDA's loan to the district was secured by a second lien on and pledge of revenue derived from the district's operations and was subordinate to HUD's loan. After meeting with district officials, EDA also knew as early as November 1969 that the district was projecting a deficit operation through 1974. The district also told EDA in April 1971 that it would not be able to make interest payments for the next 2 years. Although EDA was aware of this adverse trend, it did not act, as required by its loan management procedures, to forestall default by requiring the district to put the project on a sound financial basis. Because EDA did not request the district to increase the water rates, the district's EDA loan became delinquent. As discussed on page 5, we are of the opinion that the contract allowed raising the water rates, beginning in October 1970, by an amount sufficient to cover the debt service on the loan before the district began operations.

EDA did not work out repayment plan

After the loan became delinquent in May 1971, EDA did not restructure, or recast, the loan as required by its loan management procedures. Further, there was no documentation that any financial analysis was made after the loan became delinquent or that project visits had been made as required. The EDA official responsible for administering the public facility programs stated that EDA had not acted since HUD was the primary lender and had the lead in taking action concerning the district. He contended that any action taken alone by EDA would benefit only HUD since any revenue generated by the district would go to HUD before EDA. Therefore, EDA waited for HUD to work out a solution and took no action to require the district to raise its water rates.

The district submitted a new repayment plan to EDA in December 1977 for the repayment of delinquent interest and retirement of the loan within the stated term. As of February 1978, EDA had not approved the plan.

Even though the EDA loan was subordinate to the HUD loan, we do not believe this relieved EDA from the responsibility of working with HUD to ensure that the district repaid the principal and interest in a timely manner. We also believe that EDA should review and approve, if appropriate, the district's repayment plan.

CONCLUSIONS

Public facility loans made to the district were not managed adequately by either HUD or EDA. Neither agency took timely action to prevent the district's forecasted delinquency. Further, once the delinquency occurred, HUD took an inordinately long time to work out a solution and EDA has yet to approve a revised repayment plan on its loan.

AGENCY COMMENTS

HUD and EDA officials responsible for administering public facility loan programs agreed with our findings, conclusions, and recommendations.

RECOMMENDATIONS TO THE SECRETARIES OF HUD AND COMMERCE

Although the public facility loan program has been replaced, the balance of outstanding loans is considerable and represents a sizable Federal investment. Therefore, loan management will still be necessary for some time. To assure the Government's interest is protected and that similar situations are avoided, we recommend that the Secretaries of HUD and Commerce emphasize to their field offices the importance of (1) timely monitoring of projects to identify adverse trends, (2) taking timely action to forestall defaults, and (3) when loans become delinquent, working out effective alternatives to correct the delinquency. In addition, we recommend that the Secretary of Commerce either approve the current repayment proposal submitted by the district or direct EDA to work out an acceptable plan with the district as soon as practical.

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We are sending copies of this report to the Secretaries of HUD and Commerce, Senate Committee on Governmental Affairs, House Committee on Government Operations, House and Senate Committees on Appropriations, and other interested parties upon request, beginning 3 days after the report date.

Henry Eschwege

Henry Eschwege
Director