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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To Senator William Proxmire

RELEASED

HUD's Loan Servicing Contracts For Multifamily Mortgages Need Better Management

To improve loan servicing and accounting for Department of Housing and Urban Development-held multifamily mortgages, HUD, in late 1981, awarded a contract covering its Region III area. GAO questions several aspects of this contract's award and administration. Among other things, GAO found (1) no documented evidence that HUD considered the income accruing to the contractor from holding escrow funds for the mortgages in determining the contractor's fees and (2) that HUD has not established an adequate basis for evaluating the contractor's performance.

GAO makes recommendations to correct the problems with the Region III contract and ensure that similar problems do not occur with a nationwide contract, which is now in the final negotiation process.

UNITED STATES GENERAL ACCOUNTING OFFICE

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MARCH 14, 1983

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

B-210607

The Honorable William Proxmire
United States Senate

Dear Senator Proxmire:

As requested in your August 31, 1982, letter, this report discusses our evaluation of the Department of Housing and Urban Development's reply to questions you asked during hearings held by the Senate Appropriation's Subcommittee on HUD-Independent Agencies in May 1982. At the hearings, held to discuss HUD's fiscal year 1983 appropriations, you asked HUD to provide answers to a number of questions concerning its Region III and proposed nationwide contracts with the private sector for loan servicing and accounting functions for HUD-held mortgages.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 5 days after its issuance. At that time we will send copies to the Director, Office of Management and Budget; the Secretary of HUD; and other interested parties.

Sincerely yours,

J. Dexter Peach
Director

BY THE U.S. GENERAL ACCOUNTING OFFICE
REPORT TO SENATOR WILLIAM PROXMIRE

HUD'S LOAN SERVICING CONTRACTS FOR MULTI-FAMILY MORTGAGES NEED BETTER MANAGEMENT

D I G E S T

In December 1981, the Department of Housing and Urban Development (HUD) contracted with a private mortgage firm to perform loan servicing and accounting functions for HUD-held multifamily mortgages in its Region III area. HUD's purpose was to improve the servicing of these mortgages thereby resulting in increased revenues to the Department from the collection of outstanding debt. Also, HUD expected this contract to improve accounting and recordkeeping. In April 1982, HUD requested proposals for a nationwide loan servicing and accounting contract covering HUD-held mortgages in its other nine regions. In mid-November 1982, HUD selected a nationwide contractor, and as of March 1983 final negotiations were in process. (See pp. 1 and 2.)

Senator William Proxmire asked GAO to evaluate HUD's reply to several questions that he asked concerning the loan servicing and accounting contracts during hearings held by the Subcommittee on HUD-Independent Agencies, Senate Committee on Appropriations, in May 1982. GAO found that HUD's response was incomplete; its procurement practices for its Region III contract were deficient in several respects; and some of the problems identified with the Region III contract may apply to the nationwide contract as well.

ADEQUACY OF HUD'S ACTIONS IN AWARDING REGION III CONTRACT

HUD's records indicate that the Region III contract was designed to demonstrate the feasibility of private sector loan servicing and to develop a program to go nationwide within 3 years. The contract's utility as a demonstration was substantially reduced soon after its award because 2 months after the contract became operational, HUD announced a request for proposals for a nationwide contract. The nationwide contractor is to phase in HUD's nine remaining regions in 2- to 3-month intervals, to be completed within 2 years of contract execution. This timetable raises questions about the continuing benefit to be served by the Region

III contract once the nationwide contract is awarded. GAO believes other contract options, such as allowing for a 3-year demonstration of the Region III contract or advertising for the award of a nationwide contract initially, may have been preferable to HUD's awarding a 4-year, sole-source negotiated contract for Region III. (See pp. 5 to 7.)

In awarding the Region III contract, GAO also found that HUD did not adequately perform other related procurement functions. For example, HUD did not perform an A-76 study to determine whether it was more economical to accomplish the work in-house or by contract as required by the Office of Management and Budget. Also, HUD did not perform an adequate cost and price analysis to find out whether the contract price was reasonable. (See pp. 7 to 9.) In performing its cost and price analysis, HUD, aside from not properly verifying the contractor's cost information, did not consider and document the income that the contractor might derive from holding nearly $4 million in escrow funds (see pp. 11 to 13).

GAO concludes that these contracting deficiencies raise questions as to whether Housing's Office of Multifamily Financing and Preservation's contracting division should retain responsibility for the administration of the contracts or whether the responsibility should be given to the Office of Procurement and Contracts under the Assistant Secretary for Administration. Housing's contracting division's experience has been limited to procurement functions relating to the management and repair of HUD-acquired properties, whereas Administration's Office of Procurement and Contracts has been generally responsible for all other HUD headquarter's procurements. (See pp. 9 and 10.)

ADEQUATE BASIS NEEDED TO JUDGE SUCCESS OF PRIVATE SECTOR SERVICING

Prior to entering into the Region III contract, HUD had limited data on its own past performance and costs in collecting debts. Consequently, HUD has had difficulty in establishing a basis for comparing the contractor's work against its own. HUD prepared one statistical information report, which attempted to draw such a comparison, but GAO found that the report did not represent a logical and consistent basis for comparison. Also, HUD gathered some information for the statistical report on HUD's past performance in an inaccurate and inconsistent manner. (See pp. 18 to 20.)

To help monitor performance, HUD plans to require the nationwide contractor to develop an automated system(s) for comparing its performance with HUD's past performance. As part of this effort, HUD is considering developing a complete payment history of the mortgages to be serviced by the contractor. While HUD officials do not foresee any technical difficulties in obtaining complete payment histories, they do not know if this would be prohibitively costly. At present, requirements for this portion of the nationwide contract have not been completed. (See pp. 20 and 21.)

Regarding the monitoring of the Region III contractor's work, HUD has not made the required quarterly visits to the contractor's site to evaluate its performance. Its scheduled June 1982 visit took place a month late, while the scheduled September visit was not made until late November. HUD's evaluation report, summarizing its two visits, had not been completed despite a letter from the contractor requesting it. (See pp. 21 and 22.)

REGION III CONTRACT PAYMENT TERMS ARE UNCLEAR

The initial provisions of the Region III contract governing the contractor's basic payment fee were not clearly spelled out nor fully understood by HUD officials. For example, it was unclear as to whether the contractor had to collect a full monthly mortgage payment to be entitled to its full fee. Also uncertainty existed about how to treat the application of Federal funds for interest reduction and rent supplement payments when calculating the contractor's payment fee. To resolve these matters, HUD modified the original contract in August 1982. While these changes clarified some of the original payment provisions, GAO found that it still did not adequately explain how to perform certain computations affecting payments to the contractor. (See pp. 25 to 28.)

SEVERAL REGION III CONTRACT PROBLEMS MAY APPLY TO NATIONWIDE CONTRACT

In November 1982, HUD selected a firm other than the Region III contractor for the nationwide contract, and as of March 1983 final negotiations were in process. Should HUD decide to use payment provisions similar to the Region III contract, it may find itself encumbered with similar problems, but on a greater scale. In addition, the need, for example, to consider the use of escrow funds and the income accruing to the contractor from those funds in negotiating the contractor's fee becomes more important because it could involve about $59 million in escrow funds nationwide. (See pp. 13 and 14.)

RECOMMENDATIONS

GAO recommends that the Secretary of HUD direct that:

--The responsibility for contract administration of the loan servicing and accounting contracts be given to the Office of Procurement and Contracts under the Assistant Secretary for Administration. (See p. 10.)

--The income accruing to the Region III and nationwide contractors from holding escrow funds for the mortgages to be serviced be evaluated in detail for determining their contract fees and that the contract files be adequately documented showing the basis HUD uses in assigning a value to the escrow funds for fee negotiation purposes. (See p. 14.)

--A cost-effective system(s) be developed for comparing past HUD and contractor performance and for reporting on debt collection activities. (See p. 22.)

--The onsite monitoring visits by HUD be conducted as required and the results provided to the contractor in a timely manner. (See p. 22.)

--The Region III contract be further modified to fully explain in writing all matters on how the payment fees are to be calculated. Similar steps for the proposed nationwide contract should be taken if HUD decides to retain the Region III payment provisions. (See p. 30.)

--Contractor recommendations for workout agreements and foreclosure actions be closely monitored. (See p. 30.)

AGENCY COMMENTS AND GAO'S EVALUATION

In commenting on the report, HUD agreed with most of the recommendations made except for GAO's recommendation that responsibility for contract administration be given to the Office of Procurement and Contracts under the Assistant Secretary for Administration.

HUD agreed that the income accruing to the contractors from holding the escrow funds must be valued in establishing the net profit to the contractors to determine their contract fees, and that the contract files should be documented to reflect the basis HUD used in making this determination. Also, HUD said it was examining the various options available and their costs in the development of its planned automated system(s) for comparing past HUD and contractor performance, and that in the future it intends to conduct its onsite monitoring reviews of the contractor as required. HUD agreed to meet with GAO to resolve those areas of the payment provisions GAO believes need further clarification. HUD stated, in taking exception to the issue of who should have responsibility for contract administration of the loan servicing and accounting contracts, that this was an organizational issue currently under discussion in the Department.

GAO believes its recommendation regarding organizational responsibility for contract administration is consistent with proposed delegations of contract authority contained in a draft procurement charter currently under review in the Department. The draft charter would, among other things, designate the Assistant Secretary for Administration as the Department's Procurement Executive, pursuant to Presidential Executive Order 12352 and establish certain lines of contract authority and accountability. Specifically, it was proposed in the charter that all HUD headquarters procurement would be awarded by the Office of Procurement and Contracts. The Assistant Secretary for Housing-Federal Housing Commissioner in January 1983 expressed certain concerns with the charter but indicated his tentative concurrence with the proposal.

C o n t e n t s

ABBREVIATIONS

GAO	General Accounting Office
GTM	Government Technical Manager
GTR	Government Technical Representative
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget

CHAPTER 1

INTRODUCTION

On August 31, 1982, Senator William Proxmire asked our Office to evaluate the Department of Housing and Urban Development's (HUD's) response to certain questions he asked during hearings held by the Subcommittee on HUD-Independent Agencies, Senate Committee on Appropriations in May 1982. During the hearings on HUD's fiscal year 1983 appropriations, Senator Proxmire asked numerous questions concerning HUD's plans to contract with the private sector for certain loan servicing and accounting functions for HUD-held multifamily mortgages. Senator Proxmire's questions specifically centered around the contract the Department awarded in December 1981 for the servicing of HUD-held multifamily mortgages in the Region III area and the Department's plans for expanding the effort nationwide. Thus, the purpose of our review was to evaluate the Department's response to Senator Proxmire and to comment on any other HUD-related contracting matters.

HUD contracted with the private sector to improve the servicing of HUD-held multifamily mortgages. On December 15, 1981, the Department entered into a sole-source negotiated contract with a private mortgage firm to perform certain loan servicing and accounting functions for the inventory of HUD-held multifamily mortgages in its Region III area. This region covers HUD offices in the States of Delaware, Maryland, Virginia, West Virginia, Pennsylvania, and the city of Washington, D.C. The contract, which became operational on March 1, 1982, is for a 4-year term and provides for three additional 1-year extensions. The contract cost is not to exceed $800,000 per year and is being funded directly from the Federal Housing Administration insurance funds.

The primary functions the contractor will perform are billing and collecting mortgage payments; collecting and maintaining escrow accounts; monitoring hazard insurance policies; performing annual project evaluations; and monitoring delinquent loans, including recommending terms for workout arrangements, mortgage modifications, transfers of ownerships, and foreclosure actions. The primary benefits HUD expects to achieve under the contract are: (1) to increase revenues from the collection of outstanding debts, (2) to prevent increasing delinquencies, and (3) to stabilize and cure mortgage delinquencies.

On April 30, 1982, 2 months after the Region III contract became operational, HUD issued a request for proposals to engage a contractor on a nationwide basis to provide loan servicing and accounting services for the remaining inventory of HUD-held mortgages. The request for proposals provided that the nationwide contract would be phased in over a 2-year period and would encompass the remaining nine HUD regions. The contract will be for a 4-year term and will provide for four additional 1-year extensions. The annual cost of the contract is not to exceed $10 million. This cost will also be funded directly from the insurance funds. The closing date for responding to the request for proposals was June 30, 1982. In mid-November 1982, HUD made its selection of the firm for the nationwide contract. As of March 1983, the nationwide contract was in the final negotiation process.

The responsibility for the negotiation, award, and administration of the Region III loan servicing and accounting contract rests primarily with officials from the following offices:

Assistant Secretary for Housing-Federal Housing Commissioner

Office of Multifamily Financing and Preservation:

--The contracting officer, who is responsible for all actions necessary for effective contracting, including the development, negotiation, award, and administration of the contract.

--The Government Technical Representative (GTR), who is responsible for monitoring the technical aspects of the contract, including the contractor's progress and performance and the acceptability of the services provided.

Office of Multifamily Housing Management and Occupancy:

--The Government Technical Manager (GTM), who is responsible for the day-to-day oversight of the services performed on loan servicing matters.

Assistant Secretary for Administration

Office of Finance and Accounting:

--The Government Technical Manager, who is responsible for the day-to-day oversight of the services performed on accounting matters.

OBJECTIVES, SCOPE, AND METHODOLOGY

As requested by Senator Proxmire, we have reviewed HUD's response to specific questions asked at the May 1982 appropriation hearings held by the Subcommittee on HUD-Independent Agencies, Senate Committee on Appropriations. We have grouped these questions into four areas--see chapters 2 through 5.

The review was made in accordance with generally accepted government audit standards. Our review was performed at HUD-headquarters between August 1982 and February 1983.

We interviewed the HUD officials who prepared the Department's response to Senator Proxmire and were responsible for contracting with the private sector for the loan servicing and accounting contracts. We reviewed pertinent legislation, regulations, policies, and procedures concerning HUD's contracting efforts. We also reviewed HUD's contracting files on the Region III contract. We did not, however, review the performance of the Region III contractor and accordingly are not making any conclusions regarding its performance to date. Also, we did not perform any audit work relating to HUD's evaluation and selection of the contractor for the nationwide loan servicing and accounting contract. Our review concentrated primarily on HUD's award and administration of the Region III contract and the applicability of certain contract issues to the proposed nationwide contract.

CHAPTER 2

RESPONSIBILITY FOR ADMINISTRATION OF LOAN SERVICING AND ACCOUNTING CONTRACTS NEEDS TO BE REEXAMINED

QUESTIONS ASKED OF HUD

Senator Proxmire asked several questions on the procurement procedures followed by the Department in contracting out the loan servicing and accounting contracts. Specifically, the following major questions were asked:

--Why is the Department rushing to execute a nationwide contract before the Region III contract is completed? Also, will the Region III contractor have an advantage over other potential bidders for the nationwide contract?

--Isn't the failure to prepare an economic analysis for the Region III contract a violation of the guidelines contained in the Office of Management and Budget (OMB) Circular A-76? What is the status of your A-76 study for the proposed nationwide contract?

HUD'S RESPONSE

The Department stated that the Region III contract initially was intended and is serving as a pilot project to facilitate the implementation of a national contract in order to produce a quality service to be conducted in a timely manner. The pilot project, according to HUD, has produced and continues to produce beneficial information through each progressive phase. For instance, mortgagor and HUD records have been reconciled by the Region III contractor in those cases where disagreements existed. In addition, a comprehensive servicing manual has been developed, together with good, workable procedures, which can be used to implement a national program within a time frame significantly ahead of what was envisioned before the pilot project. According to HUD, this will enable the Department to more readily achieve the debt collection goals.

HUD stated that all bidders would have the same opportunity to be selected for the nationwide contract. HUD said the majority of potential bidders showing interest in the request for proposals have the demonstrated and/or potential capability and experience needed. Conversely, the majority, including the Region III contractor, do not have the required nationwide network in place to accommodate the regional phase-in and the computer systems and reporting capabilities needed. Nevertheless, these bidders will have the same opportunity as everyone else to provide an administrative plan and organizational arrangement as part of their proposal, according to HUD.

Regarding the questions relating to requirements of OMB Circular A-76, HUD stated that an economic feasibility analysis was conducted for the Region III contract, but it did not follow the format of OMB Circular A-76 because of the differences in the services performed by the Department and those required by the contract. HUD said, however, that a cost-benefit study, as required by OMB Circular A-76, is currently underway and would be completed before the Department negotiates and executes a contract for nationwide use.

GAO ANALYSIS OF HUD RESPONSE

While we agree that the Region III contract has been of some benefit to HUD in its procurement of a nationwide contract, we question what continuing benefit the Region III contract will serve once the nationwide contract is executed and the various HUD regions are phased-in under the contract. We believe, as an internal HUD document states, that other contract options such as allowing for a 3-year demonstration of the Region III contract or advertising for the award of a national contract initially would have been preferable to the procurement action HUD followed. Also, HUD told us that the Region III contractor did not have an advantage over other bidders in the selection of the nationwide contractor. In mid-November 1982, HUD selected a firm other than the Region III contractor for the nationwide contract.

Regarding Senator Proxmire's question concerning the OMB Circular A-76 studies for the loan servicing and accounting contracts and other related procurement matters, we found that:

--HUD did not perform an A-76 study for the Region III contract as required by OMB Circular although they informed us that one has been prepared for the nationwide contract.

--HUD did not perform an adequate cost and price analysis in negotiating a fee for the Region III contract.

--HUD failed to adequately draft clear and concise payment provisions for the Region III contract.

These procurement deficiencies raise questions whether Housing should retain responsibility for contract administration for these functions or whether the responsibility should be given to the Office of Procurement and Contracts under the Assistant Secretary for Administration.

Limited benefit of Region III contract in implementing nationwide contract

Our review of HUD contract files disclosed an internal fact sheet dated October 13, 1981, stating that initially HUD intended to execute a sole-source demonstration contract to test the concept and develop a program to go nationwide within 3 years. The fact sheet indicated that the Department was facing reductions in staffing, and that if HUD were to accomplish its objectives as well as absorb staff reductions it must find ways to reduce its workload. The fact sheet states that the workload would be drastically reduced in the Office of Finance and Accounting and field offices if it did away with the demonstration portion and implemented immediately a 2-year phase-in of the contract. Three options were outlined in the fact sheet: (1) continue 3-year demonstration; (2) go for a request for proposals to phase-in concept over 2 years and, as phased-in, make adjustments as found necessary; and (3) go demonstration in Philadelphia region and almost simultaneously go request for proposals in the other nine regions. The recommendations contained in the fact sheet indicated that option 1 was administratively preferable, but that due to reductions in staff it was not practicable. Option 2 was judged the most practicable and workable, whereas option 3 was judged as a compromise leaving the Department with a slight credibility gap. Contract execution for the demonstration portion was estimated for December 15, 1981, under options 1 and 3. Under option 2, February 1, 1982, was estimated as the contract execution date for a nationwide contract.

This fact sheet, in our opinion, raises questions about HUD's contention that the Region III contract was intended as a pilot to facilitate the implementation of a nationwide contract. If intended as a pilot, we question the benefit or value the pilot will serve once the nationwide contract is executed since the performance of the nationwide contractor will be governed by the contract that it executes with HUD as is the Region III contractor governed by the contract it executed in December 1981. The timetable for the successful nationwide contractor to be fully operational within 2 years translates into it having to phase-in one HUD region about every 3 months after the date of contract execution. Accordingly, we fail to see how the Region III contract will be of continuing benefit in light of the nationwide timetable for the contractor to be fully operational in 2 years.

We also believe the limited benefit that is to be derived from the Region III contract, once the nationwide contract is executed, raises questions about the sole-source nature of the Region III contract and the length of the contract term. We noted that the sole-source, noncompetitive nature of the procurement and the contract term were also similarly questioned within HUD. The Office of Procurement and Contracts, under the Assistant Secretary for Administration disagreed with the award of the contract on a sole-source basis. The former Director of the Office of Procurement and Contracts, in an August 20, 1981, memorandum on the proposed contract, stated that he found nothing in the proposal to justify going to the particular contractor on a noncompetitive basis. He stated that the services to be contracted were likely to be available from another private source, and therefore, HUD's policy of obtaining competition applied. He concluded that requiring competition is the only way to ensure that fair and reasonable prices will be paid by the Government for these non-unique services.

Other officials in HUD such as the Associate General Counsel for Regulations and Administrative Law and the former Director, Office of Multifamily Financing and Preservation similarly noted their concerns about whether a sole-source contract could be justified. Although the Deputy General Counsel of HUD concluded in November 1981 that there was sufficient justification for a noncompetitive procurement, it should be noted that he also concluded that 36 months (presumably the proposed contract term at the time of his review) was an unusually long period of time for a sole-source contract.

Although we question the procurement decisions HUD made in securing the Region III and nationwide loan servicing and accounting contracts, HUD told us that the Region III contractor did not have an advantage over other bidders for the nationwide contract. HUD officials told us that they shared, to the extent possible, the information obtained as a result of the Region III contract with all bidders. Also, HUD established a separate panel to review the report and recommendation made by the source evaluation board for the award of the nationwide contract. Finally, it should be noted that in mid-November 1982, HUD selected a firm other than the Region III contractor for the nationwide contract.

<u>Other related procurement functions were not adequately performed for Region III contract</u>

In its procurement of the Region III loan servicing and accounting contract, HUD failed to adequately perform several other related procurement functions. HUD did not perform the required OMB Circular A-76 study for the contract; it did not perform an adequate cost and price analysis for negotiating the fee of the contract; and it failed to establish clear and concise payment fee provisions in the original contract. These procurement deficiencies raise questions whether Housing's Office of Multifamily Financing and Preservation's contracting division should retain responsibility for contract administration for these functions or whether the responsibility should be given to the Office of Procurement and Contracts under the Assistant Secretary for Administration which has generally been responsible for all headquarter's procurements.

HUD's response indicated that an A-76 study to determine if it was more economical to do the work in-house or by contract was not performed for the Region III contract as required by OMB because of the differences in the services performed by the Department and those required by the contract. In discussing this matter further with Housing officials, the Housing GTM from the Office of Multifamily Housing Management and Occupancy said that an A-76 study was not conducted since it was his understanding that they were not required for pilot projects. The Housing GTM based his conclusion on a November 23, 1981, memorandum from the Assistant Secretary for Administration which stated that "before the project can be expanded past the pilot stage, a cost comparison study should be completed in accordance with OMB Circular A-76." In discussing this matter with OMB, we were told by an official in the Office of Federal Procurement Policy that pilot contracts were not exempted from the requirements of OMB Circular A-76. HUD's Housing GTM and contracting officer told us that the A-76 study for the nationwide contract has been completed.

A fundamental concept of Government procurement is that competition assures a fair and reasonable price. However, where negotiation is authorized, certain restrictions upon the competitive process are usually present. To compensate for these inherent restrictions on competition, guidelines have been established for use by contracting officers in determining whether a negotiated proposal is fair and reasonable. HUD's procurement policies and procedures state that regardless of the method used in awarding a contract, each award is subject to the determination of reasonableness of price by the contracting officer. It states that some method of cost or price analysis is required as a basis for making this determination and directs the contracting officer to require preaward audits of contracts of $100,000 or more as a pricing aid. HUD's procurement policies and procedures designate the Office of Inspector General the responsibility for providing price evaluation and audit reviews of cost and price data submitted by contractors, when requested to do so by the contracting officer. The evaluations or audits are made on contractors' proposals in accordance with generally accepted auditing standards, taking into consideration allowable and unallowable costs and reasonableness thereof in accordance with the Federal Procurement Regulations.

A cost analysis involves the detailed review and evaluation of a contractor's cost or pricing data, including an appropriate verification of the cost data and an evaluation of the specific elements of the costs. The effect of these costs on prices can be seen by examining factors such as the necessity of costs, the reasonableness of estimates, the basis for allocation of overhead costs, and the appropriateness of particular overhead costs.

Based on our review of HUD's contract files and discussions with the Housing contracting officer, we believe HUD failed to perform an adequate cost and price analysis to determine the reasonableness of the Region III contract price. HUD failed, among other things, to consider and document in its cost and price evaluation the income to be derived by the contractor from it holding the escrow funds. This is a significant matter considering that approximately $3.9 million in escrow funds was initially transferred to the contractor. (See ch. 3.) In addition to the omission of the escrow funds, there is limited information or supporting documentation in the contract files to assess the effort HUD made in verifying the accuracy or reasonableness of the cost information submitted by the contractor. The contracting officer told us that he did not make an onsite review of the contractor's financial records to verify the costs nor did he request a preaward contract audit of the contractor's cost and pricing data by the Office of Inspector General as is directed by HUD's procurement policies and procedures. Although a certificate of current cost or pricing data was submitted to the contracting officer, this certificate should not be considered a substitute for the contracting officer's independent examination and verification of the cost or pricing data.

The original payment fee provisions of the Region III contract were not clearly defined nor fully understood by the various HUD officials responsible for administering the contract. Because the payment provision did not address many critical issues, HUD in August 1982 had to issue a modification to the contract to clarify the payment provisions. The modification still does not, in our opinion, define certain matters fully. (See ch. 5.)

CONCLUSIONS

While we agree that the Region III contract has been of some benefit to HUD in its procurement of a nationwide contract, we question what continuing benefit the contract will serve once the nationwide contract is executed and the various HUD regions are phased-in under the contract. We believe other options such as allowing for a 3-year demonstration of the Region III contract or advertising for the award of a nationwide contract initially would have been preferable to the procurement action HUD followed. This decision, in conjunction with HUD's failure to prepare an A-76 study for the Region III contract, the failure to perform an adequate cost and price analysis, and several other procurement inadequacies discussed later in this report, raise questions as to whether Housing's Office of Multifamily Financing and Preservation's contracting division should retain responsibility for the administration of the loan servicing and accounting contracts. Although we believe some of the deficiencies relating to the procurement of the Region III contract may be attributable to the apparent desire of Housing to have this contract operational as soon as possible, we question whether these deficiencies would have occurred if the Office of Procurement and Contracts under the Assistant Secretary for Administration had been responsible for the procurement.

Housing's Office of Multifamily Financing and Preservation's contracting division's experience has been limited to procurement functions relating to the management and repair of HUD-acquired properties, whereas Administration's Office of Procurement and Contracts has been generally responsible for all other HUD headquarter's procurement. We believe that by giving the contract administration responsibilities to the Office of Procurement and Contracts, there would be an added degree of independence between the program and contracting officials. We believe there is insufficient justification to expand the responsibilities of Housing's Office of Multifamily Financing and Preservation's contracting division beyond its current functions for the management and repair of HUD-acquired projects and that the responsibility for the administration of the loan servicing and accounting contracts for HUD-held multifamily mortgages be given to Administration's Office of Procurement and Contracts.

RECOMMENDATION TO THE SECRETARY, HUD

We recommend that the Secretary of HUD direct that the responsibility for the contract administration for loan servicing and accounting contracts for HUD-held multifamily mortgages be given to the Office of Procurement and Contracts under the Assistant Secretary for Administration.

AGENCY COMMENTS AND OUR EVALUATION

HUD said that the issue of who should have responsibility for the contract administration of the loan servicing and accounting contracts was an organizational matter currently under discussion in the Department. In the past, the Assistant Secretary for Administration has proposed that it be responsible for all headquarter's procurement except for the repair of acquired projects.

We believe our recommendation regarding organizational responsibility for contract administration is consistent with proposed delegations of contract authority contained in a draft procurement charter currently under review in the Department. The draft charter would, among other things, designate the Assistant Secretary for Administration as the Department's Procurement Executive, pursuant to Presidential Executive Order 12352 and establish certain lines of contract authority and accountability. Specifically, it was proposed in the charter that all HUD headquarters procurement would be awarded by the Office of Procurement and Contracts. The Assistant Secretary for Housing-Federal Housing Commissioner, in January 1983, expressed certain concerns with the charter but indicated his tentative concurrence with the proposal. Specifically, he stated that Housing would now process all, except acquired property procurement actions, through the Office of Procurement and Contracts. At the conclusion of our review, the draft procurement charter was still under review within the Department.

CHAPTER 3

VALUATION OF ESCROW FUNDS IN NEGOTIATING

PRICES FOR LOAN SERVICING AND ACCOUNTING CONTRACTS

QUESTION ASKED OF HUD

Did HUD consider the value of the interest-free use of the $3,947,892.87 in escrow funds which is held by the Region III contractor in establishing the contract price?

HUD'S RESPONSE

HUD stated in its response to Senator Proxmire that the float of the escrow funds was considered and negotiated between the contractor and HUD in determining a very low fee structure. HUD also explained that the float amount is not constant due to the varying tax cycles.

GAO ANALYSIS OF HUD RESPONSE

HUD's contract files contained no evidence to substantiate that the value of about $4 million in escrow funds was considered in determining the fee for the Region III contract. HUD's cost and price evaluation for determining the reasonableness of the negotiated fee for the contract contained no information on the escrow funds and specifically how HUD valued the funds in negotiating the fee for the contract. Although the Housing GTM told us the escrow funds were taken into consideration in negotiating the fee structure, the Housing contracting officer, who was solely responsible for negotiating the contract, said that he did not consider the value of the escrow funds in negotiating the fee for the contract. Because the proposed nationwide contract, currently in the award process, could involve the transfer of about $59 million in escrow funds, a value needs to be assigned to the escrow funds for negotiating the contractor's fee.

No documented evidence available to support HUD consideration of escrow value in negotiating Region III contract

The Region III loan servicing and accounting contract provides for the contractor to be responsible for collecting monthly escrows for real estate taxes, hazard insurance, and reserve for replacements. All funds collected are to be deposited in an escrow account and are to be in an institution insured by the Federal Deposit Insurance Corporation. From the escrow account, the contractor is to make payments for taxes, hazard insurance premiums, and servicing charges. Also, the contractor is responsible for, among other things, conducting escrow analysis for taxes and for the processing of requests for withdrawals from the reserve for replacement accounts. Escrow funds for taxes, reserve for replacements, and selected miscellaneous escrows were transferred from the insurance funds to the Region III contractor for the 144 HUD-held mortgages to be serviced as follows:

Tax escrows	$2,286,379.43
Reserve for replacements	1,542,211.65
Miscellaneous escrows	119,301.79
Total	$3,947,892.87

Additional reserve for replacement escrows that HUD invested for the benefit of the project owners in federally insured outside depositories and U.S. Securities will be transferred to the contractor when they reach maturity. Also, the contract provides that the contractor will escrow for hazard insurance premiums, which HUD previously has never done. The Region III loan servicing manual states that reserve for replacement funds in excess of 3 months' deposit requirement shall be invested on behalf of the project owners on those mortgages where payments are current or current under an approved workout arrangement.

In discussing the contractor's use of the escrow funds, specifically the potential revenues that would result from the contractor holding the escrows, with the Office of Multifamily Housing Management and Occupancy GTM on June 11, 1982, we were told that the contractor is allowed to use the funds for its own benefit. The Housing GTM stated that the "float" from the escrows was considered by HUD and the contractor during negotiations for establishing the payment fee structure under the contract. According to the Housing GTM, most collection bureaus charge between 20 to 60 percent of the amounts they collect. He said the contractor's ability to use the escrow funds offsets what he believes to be a very low payment fee provided under the contract. We told the Housing GTM that in reviewing the contract files, specifically the cost and price analysis, we did not find any evidence to indicate that HUD considered the contractor's use of the escrow funds in establishing the fee structure. The Housing GTM agreed that there was no supporting documentation in the contract files and stated that HUD should have documented how the escrow funds were valued in negotiating the contract price.

The Housing GTM said that the contractor would not have available the entire $3.9 million in escrow funds for investment use. He said, for example, that the total amount of escrow funds held by the contractor was not constant due to varying tax cycles. Also, he said the contractor is advancing funds for up to 45 days when the escrow balances of project owners were insufficient to meet the tax expenses. Also, he pointed out the requirement for the investment of reserve for replacement escrows on the behalf of project owners. We asked the Housing GTM how much was available for investment, how the contractor was using the escrow funds, and how much the contractor was earning from its use. The Housing GTM, however, was unable to provide this information and stated that he would have to ask the contractor to supply it to HUD.

Subsequently, on June 21, 1982, the Housing GTM told us that the contractor reported as of May 31, 1982, that it had about $4.2 million in escrow funds. The GTM said the amount of escrow funds increased because the contractor was escrowing for hazard insurance premiums, which HUD has never previously done. He said the contractor told him that it was using the escrow funds to obtain a line-of-credit which in turn was being used to make short-term investments. The GTM said the contractor was able to earn about a 6-percent rate-of-return on the escrow funds. Also, the GTM informed us that HUD had not yet sent the necessary forms to the contractor that are required to obtain the permission of the project owners to invest the reserve for replacement escrows but would be doing so in the near future.

In August 1982, we discussed the escrow fund transfer with the Housing contracting officer. We told the contracting officer that we could find no evidence in the contract files to support HUD's contention that the value of the escrow funds to the contractor was considered in negotiating the fee for the Region III contract, and that the cost and price evaluation HUD made to determine the reasonableness of the contract fee made no reference to the escrow funds and/or how HUD valued them in negotiating the fee for the contract. The contracting officer stated that he did not consider the use of the escrow funds during the contract fee negotiations. The contracting officer knew that the contractor would be required to maintain the tax escrow accounts but did not know the amount of total escrow funds that would be transferred to the contractor nor the potential revenue to be earned by the contractor. Also, the contracting officer said that he did not delegate any negotiation responsibilities to other Housing officials since he is solely responsible for these functions.

Need to value escrow funds for nationwide contract

The valuation of the escrow funds for negotiating a payment fee for the nationwide contract is particularly important since it could involve the transfer of about $59 million in escrow funds. We believe this may be a difficult task and therefore will require that HUD evaluate a number of variables that directly have an effect on the value of the escrow funds. HUD will need to evaluate the changes that will occur in the composition of the HUD-held inventory. For example, HUD will need to evaluate and project potential increases to the inventory resulting from new assignments and sales of acquired projects with purchase money mortgages and decreases to the inventory resulting from mortgage sales and foreclosures. Projections concerning anticipated interest rates will be necessary in assigning a value to the escrow funds. Also, HUD should closely examine and evaluate its accounting records to obtain relevant historical information about escrow balances on the nationwide inventory; including the trends that occur in the escrow balances due to the varying tax cycles. HUD should also review the Region III contractor's escrow records for application to the nationwide contract. For example, HUD should examine matters such as the potential value associated with escrowing for hazard insurance premiums and the relative accuracy with which HUD was escrowing for taxes before the Region III contract compared to the results shown by the contractor's escrow analysis. HUD's evaluation of the variables and the effect that they have on the contractor's fee should be adequately documented in HUD's contract files.

CONCLUSIONS

Because we could not find any documentation to support that HUD considered the value of the escrow funds to the contractor in negotiating the price of the Region III contract, we believe HUD should reevaluate the price of the contract on its anniversary date in accordance with the price redetermination clause of the contract. In reevaluating the price of the Region III contract, HUD should clearly document its contract files to show the valuation of the escrow funds and how this was considered in negotiating the fee of the contract. Because the proposed nationwide contract, currently in the award process, could involve the transfer of about $59 million in escrow funds, a value needs to be assigned to the escrow funds for negotiating the contractor's fee and the results should be documented in the contract file.

RECOMMENDATIONS TO THE SECRETARY, HUD

We recommend that the Secretary of HUD direct that

--the Region III contractor's fee be reevaluated on its anniversary date in accordance with the prospective price redetermination clause of the contract,

--a detailed evaluation be performed of the many variables that impact on assigning a value to the escrow funds for negotiating a fee for the nationwide contract, and

--the basis used in reevaluating the contractor's fee for the Region III contract and in evaluating the variables that will impact on assigning a value to the escrow funds for negotiating the fee for the nationwide contract be fully supported and documented in the contract files.

AGENCY COMMENTS AND OUR EVALUATION

HUD officials said that it agreed the income accruing to the Region III and nationwide contractors from holding the escrow funds must be valued in establishing the net profit to the contractors in order to determine contract fees. HUD said that in accordance with the redetermination clause of the Region III contract, it intends to examine the actual value of the escrows to the contractor at the end of each year of the contract for negotiating the contract fee for the following year. HUD said that for the nationwide contract, it has estimated that the escrows will yield to the contractor a 5-percent rate-of-return for each million, and that the contractor will have an average of $44 million in liquid escrows available for use in the first year. HUD said that in the second and subsequent years, the fee may be adjusted prospectively considering the previous years' actual experience for the escrow balances.

Because the price redetermination clause for the Region III and nationwide contracts is prospective and not retroactive, it is important that HUD adequately consider all the variables that may have an affect on the value of the escrows to the contractors. For the Region III contract, HUD should, based on the actual experience during the first year of the contract, have a fairly sufficient basis for valuing the escrow funds for negotiating the contract fee for the second year of the contract.

However, as discussed on pages 13 and 14 of our report, this determination may be more difficult for the nationwide contract because of the lack of comparable experience. We are concerned about HUD's apparent plans to use $44 million in escrows as the base for negotiating the fee of the nationwide contract. The $44 million estimate reflects the cash escrows for the nationwide inventory on hand by the end of May 1982 less cumulative outstanding advances. Because the composition of the HUD-held inventory may have changed since the estimated balance of escrows was initially determined, HUD should review its records to determine the most current escrow balances. Also, the $44 million estimate pertains to the entire nationwide inventory and appears not to reflect HUD's plans to phase-in the contract region by region over a 2-year period. On the other hand, it should be noted that the $44 million estimate does not actually reflect the actual amount of cash escrows on hand and that would be eventually transferred to the contractor. According to information provided by the Office of Finance and Accounting from its records, the actual gross cash escrows on hand for the nationwide inventory for the 6-month period from March 1982 thru August 1982, averaged about $59 million per month or $15 million more than the $44 million estimate.

CHAPTER 4

HUD NEEDS TO DEVELOP A COST-EFFECTIVE

METHODOLOGY FOR MEASURING AND REPORTING ON

DEBT COLLECTION PERFORMANCE

QUESTIONS ASKED OF HUD

Senator Proxmire asked HUD to respond to several questions on the benefits that were expected from contracting with the private sector to service HUD-held multifamily mortgages, and how the contractor's performance to date compared with past HUD performance. Specifically, HUD was asked:

--What stated goals does HUD expect to achieve as a result of the Region III contract? What are the costs and benefits to be derived from the Region III contract? What were the Department's yearly costs for the services covered by the contract?

--What was the collection rate for the multifamily projects in the Region III office for the 12-month period prior to the Region III contract? How does HUD's past performance compare with that of the Region III contractor's to date?

HUD'S RESPONSE

HUD responded to Senator Proxmire that the expected goals to be achieved from the Region III contract include (1) establishing and maintaining current and accurate accounting data and reporting by project accounts, (2) protecting security interest in the mortgages, and (3) getting and maintaining the inventory in a current status. HUD said that the expected benefits to be derived are (1) substantially increased revenues to the Department from the collection of outstanding debt, (2) more aggressive servicing to prevent increasing delinquencies, and (3) the stabilization and curing of delinquencies. HUD stated that bringing the mortgages current will increase the value of the assigned notes and reduce the need for foreclosure. In addition, HUD said that the contract would strengthen existing accounting systems and provide a more consistent and accurate tracking and maintenance of accounts collection and servicing data. HUD stated that it was preparing an A-76 study for executing a nationwide contract for similar services covered by the Region III contract, which should provide a better understanding of the services in relation to costs.

In response to the questions on HUD's past debt collection performance and how this compared to the efforts of the Region III contractor to date, HUD stated that data were being gathered manually to provide information for the 12-month period prior to the contract. It said, however, automated system(s) were being developed which will enable the Department to retrieve collection data for accounts before March 1, 1982, when the Region III contractor started its billing and collection functions. HUD said that the statistical data and systems development would provide this type of information in detail. HUD said that a preliminary calculation, however, indicated that the Department's collection rate nationwide was approximately 15 to 20 percent of the total outstanding balances. Because this preliminary collection data could not be identified readily by Region, HUD said the Region III contractor's performance could not be compared with the Department's performance in Region III. HUD said, however, the Region III contractor's first 3 months of operation indicated collections of approximately 60 to 65 percent of total outstanding balances.

GAO ANALYSIS OF HUD RESPONSE

HUD's response to Senator Proxmire on its stated goals and the expected benefits to be achieved under the contract compared to HUD's past costs for the services are stated in general terms. The lack of quantitatively stated goals in HUD's response may be due, in part, to the fact that HUD accumulated very limited data on its past performance and costs in collecting debts before entering into the Region III contract. Also, HUD's attempts to date to compare the performance of the Region III contractor in collecting debts to past HUD performance have not been successful. We found that an August 10, 1982, statistical report that HUD prepared for inclusion in its first quarterly monitoring report comparing the Region III contractor's debt collection performance to past HUD performance did not represent a logical and consistent basis for comparing their respective performances.

As part of the proposed nationwide loan servicing and accounting contract, HUD is planning to develop automated system(s) to accumulate information on past HUD performance in collecting debts nationwide so it can be compared to the successful nationwide contractor's performance. The Department has not yet detailed how or the basis they will use to make this comparison since the proposed contract is still under development and will be part of a phase II negotiation with the successful nationwide contractor. In developing the automated system(s), HUD should assure itself that the eventual basis or methods chosen for comparing HUD and contractor performance and used for reporting on debt collection activities represents a sound and consistent basis for reporting, and that the costs of the automated system(s) do not exceed the benefits to be derived. Also, HUD needs to ensure that it conducts its monitoring visits and completes its reports to the contractor on time.

HUD's comparison of the Region III contractor's performance to past HUD performance has not been successful

One of the primary objectives of HUD's Region III, as well as the proposed nationwide contract for private sector servicing of HUD-held mortgages, is to increase the collection of outstanding debt owed to the Department through more aggressive loan servicing. The aggressive servicing of loans would, according to HUD, prevent increasing delinquencies and would ultimately result in maintaining the inventory of mortgages in a current status.

We found, however, that the Department entered into its loan servicing and accounting contract for Region III without first determining how successful it had been collecting debts in that region. The Department, in its response to the Subcommittee, acknowledged that it did not have data on its prior experience in collecting debts in Region III, but stated that nationwide HUD's past collection rate had been approximately only 15 to 20 percent of total outstanding balances. HUD stated that the first 3 months of the Region III contractor's operations showed a collection rate of approximately 60 to 65 percent of outstanding balances.

Because data had not been accumulated on the past performance of HUD in collecting debts, we analyzed its collections in Region III for February 1982--the month before the contractor began servicing the mortgages. For the 144 HUD-held mortgages covered by the contract, HUD had collected about 69 percent of the monthly amounts due under the original terms of the mortgages, including the application of Federal subsidy funds. Exclusive of the Federal funds, the collection rate was about 49 percent. Although we realize that the February collection rate may not be typical and that a longer comparison period is desirable, we believe that it provides an indication that the collection rate cited for the contractor for the first 3 months of operation may not represent a substantial improvement over HUD's past performance. We also were unable to substantiate or document the nationwide collection rate of 15 to 20 percent of outstanding balances that HUD cited on its past performance in collecting debts nationwide.

Subsequent to the execution of the Region III contract, HUD attempted to manually accumulate data on its past collection performance for the 12-month period prior to the contract. HUD planned to use this information in evaluating the contractor's performance in relation to HUD's past collection performance.

At the request of the GTM for the Region III contract from the Office of Multifamily Housing Management and Occupancy, the Office of Finance and Accounting, which is responsible for the financial accounting for HUD-held mortgages, prepared a collection schedule for the period March 1981 through February 1982. This schedule showed the amount of cash that was collected from project owners that was posted to the three accounts of service charge, interest, and principal. The GTM, from the Office of Finance and Accounting, told us that the three accounts were chosen for the analysis since they represent receipts to the insurance funds; the other accounts for tax and reserve for replacement escrows represents funds that HUD holds in trust on behalf of project owners. The data collected on HUD's past performance was then provided to the Housing GTM who in turn prepared a statistical report comparing HUD's past performance to that of the contractor. The statistical report, dated August 10, 1982, covered the first 4 months (March through June) of the contractor's performance and the same 4 months of 1981 when HUD was servicing the mortgages. The statistical information report, which was submitted for inclusion in HUD's first quarterly monitoring visit report, to our knowledge, is the only official report that HUD has prepared comparing HUD past performance in collecting debts to that of the contractor.

After reviewing the report prepared by the Housing GTM, we met with the Accounting GTM to determine if the information accumulated on HUD's collections was comparable to that reported for the contractor. The Accounting GTM told us that there were several variables which, in his opinion, precluded a comparison of HUD's and the contractor's performance on the basis chosen for the analysis. He cited the application of Federal subsidy funds for interest reduction and rent supplement payments as the primary variable that precluded a comparison. The Accounting GTM said the analysis Housing prepared was intended to show only cash collections received from project owners and that the application of Federal subsidy funds was to be excluded from the analysis. The Accounting GTM said that although no Federal subsidy funds were included in the statistical information reported, the application of Federal subsidy funds still has a direct effect on the cash collection amounts reported in the analysis for the three accounts. He said this impact results because of the prescribed sequence HUD uses to apply funds to the accounts--service charge, taxes, interest, principal, and reserve for replacements--and "when" the Federal subsidy funds are applied in relation to the cash payments by the owner.

The Accounting GTM explained, for example, that if Federal subsidy funds are applied before the cash payments, then the Federal subsidy funds would likely be sufficient to cover the amounts due for service charge and taxes and the cash payments accordingly would be applied to the remaining accounts of interest, principal, and reserve for replacements. If on the other hand the cash payments are applied before the Federal subsidy funds, then cash payments would likely be sufficient to cover the amounts due for service charge and taxes and the Federal subsidy funds would be applied to the remaining accounts. He said, conceivably that identical amounts of cash could be collected in any two consecutive months, but that the cash collections applied to the three accounts for these months will differ if the Federal funds were posted before the project owner's cash payments in one month and vice versa the next month.

The Accounting GTM said that the difficulty relating to the application of Federal subsidy funds is the differences in the way HUD posted or applied these funds to the accounts during the period covered by the analysis. The Accounting GTM stated that before HUD's implementation of its automated accounting system in September to October 1981 that HUD manually posted the Federal subsidy funds, and as a result there was no specific or consistent date on which these Federal funds were posted to the accounts from month to month. The GTM stated that since HUD instituted its automated accounting system the Federal subsidy funds for interest reduction payments are systematically applied on the first day of each month, and the rent supplement payments are still posted manually and at varying times during the month as they were done previously. In conclusion, the Accounting GTM stated that because Federal subsidy funds have not been applied in a consistent manner for the period covered by HUD's past performance and the contractor's performance, HUD is precluded with any degree of reasonableness to judge the effect this could have on the information shown for cash collections to the three accounts.

In addition to the basis used for comparing past HUD performance to the contractor's performance, we found certain problems in the accuracy and consistency by which HUD accumulated the information on HUD's collections. To verify the data's accuracy, we checked the data on 36 of the 144 mortgages included in HUD's schedule for the month of February 1982. The figures shown in HUD's schedule were incorrect in 11 of 36 cases tested. In addition, HUD inadvertently changed the methodology it used in gathering the cash collection data for the three accounts throughout the 12-month period. In the early months, HUD considered the timing of the application of the Federal subsidy payments in relation to the payments made by the owners. In later months, however, no consideration was given as to when the subsidy payments were applied, and the cash payments were assumed to have been applied first--resulting in an inconsistent data gathering process for the 12-month period.

HUD plans to develop automated system(s) to compare HUD and contractor performance for nationwide contract

According to officials from the Office of Finance and Accounting, HUD plans to require for the proposed nationwide contract the contractor to develop automated system(s) for comparing HUD's past performance with that of the contractor. HUD is considering developing a complete payment history on each mortgage that is to be handled by the contractor. By accumulating this type of information, HUD then should be in a position to compare its past collection performance to that of the contractor. The Accounting officials said, however, that the Department had not yet developed what basis will be used to make this comparison. The officials said that they did not envision any technical difficulties in going back and obtaining a complete payment history, but they did not know whether it would be cost prohibitive.

The Housing GTM said that it was difficult at this time to precisely state how HUD will measure or evaluate debt collection performance by the successful nationwide contractor with prior HUD performance since the statement of work outlining the accounting requirements for the phase II negotiation had not been completed. He envisioned, however, that there possibly would be several bases for comparison, such as amounts due compared to amounts collected, and reduction of delinquencies, including an aging of delinquencies. We were told that HUD contemplates having the evaluation requirements of phase II fully implemented within 2 years of the successful negotiation of the requirements. The Housing GTM said, however, that the contractor's success in collecting debts is not the only basis to measure the success of the third-party servicing effort. He cited, for example, the procedures HUD had established for monitoring contractor's performance through its quarterly onsite monitoring visits. We found, however, such reviews have not been performed as required under the Region III contract.

HUD not monitoring contractor's performance as required

The Region III, as well as the proposed nationwide loan servicing and accounting contract, contains requirements for monitoring contractor performance. For example, the Region III contractor is required to submit quarterly progress reports and a first year performance report comparing contractor costs to the costs that HUD would have incurred if it had performed the same services. HUD is required, at a minimum, to make quarterly visits to the Region III contractor's site of operations to evaluate the contractor's performance.

For site visits, HUD has established certain evaluative criteria and methods of measure for evaluating the contractor's performance. Based on the site visits and the data provided by the contractor, HUD is to evaluate the contractor's overall effectiveness, quality of its work, and timeliness of its services.

Since the Region III contract became effective on March 1, 1982, the first quarterly site visit evaluating the contractor's performance should have been made at the beginning of June 1982. However, HUD did not make its first scheduled visit until July 1982, and the second required quarterly monitoring visit was not made until late November 1982. The second onsite visit should have been made during the early part of September 1982. We believe HUD needs to ensure that it meets its monitoring commitments if it is to have an adequate basis for evaluating the contractor's performance and for providing feedback to the contractor on areas needing improvement. In an October 25, 1982, letter, the contractor told

HUD that it had not received the first quarterly report, and stated that it is difficult to improve that which HUD feels are weaknesses until those weakenesses are known.

CONCLUSIONS

HUD's attempts to manually accumulate data on HUD's past debt collection performance and compare it to the performance of the Region III contractor's have not yet been successful. The debt collection data HUD developed on its past performance was not comparable to the data on the contractor's debt collection performance. We believe, as in the case of the Region III contract, there are many variables that make it difficult to report on and compare HUD and contractor performance. Accordingly, HUD's plans for developing automated system(s) for comparing debt collection performance should be thoroughly reviewed and tested to ensure the resulting data is comparable and accurate for comparison purposes and is of sufficient management utility considering its costs. We believe HUD should utilize the expertise of its Policy Development and Research staff to assist in developing the proposed automated system(s) and other evaluation studies that might be undertaken. Also, HUD needs to ensure that it conducts its required monitoring visits and completes its reports to the contractor on a timely basis.

RECOMMENDATIONS TO THE SECRETARY, HUD

We recommend that the Secretary of HUD direct that

--HUD develop a cost-effective system(s) for comparing past HUD and contractor performance and for reporting on debt collection activities. To assist in ensuring the system(s) represent a sound and consistent basis for reporting and that the costs of the system(s) do not exceed the anticipated benefits, the Department should utilize the expertise of its Policy Development and Research staff.

--The onsite monitoring visits by HUD be conducted as required and that the report on the results of the visits be provided to the contractor in a timely manner.

AGENCY COMMENTS

HUD is currently negotiating with the nationwide contractor on the proposed development of automated system(s) for comparing past HUD and contractor performance in collecting debts. HUD said it is attempting to get the contractor to accomplish this task concurrent with the implementation of phase I of the contract and at no cost to HUD. HUD and the contractor are examining various ways on how to go about accumulating historical payment histories at minimal costs. HUD intends to make onsite monitoring visits as required. HUD's second monitoring visit of the Region III contractor was made in late November 1982, and it is in the process of writing a 6-month report covering both the first and second monitoring visits. For the nationwide contract, HUD said it will conduct its monitoring reviews twice a year rather than quarterly.

CHAPTER 5

PAYMENT FEE PROVISIONS NEED TO BE CLARIFIED AND CONTRACTOR RECOMMENDATIONS FOR WORKOUT AGREEMENTS AND FORECLOSURES CLOSELY MONITORED

QUESTION ASKED OF HUD

Senator Proxmire expressed concern over the payment provisions and the incentives that existed for the Region III contractor to improve debt collections. HUD was asked to elaborate on whether the contractor's basic payment fee was dependent on the collection of the full monthly payment or only the applicable service charge 1/ amount of the full monthly payment.

HUD'S RESPONSE

In its response to Senator Proxmire, HUD stated that the contractor was entitled to its basic service fee only when the full monthly payment was collected. HUD explained that a full payment is the full amount due under the terms of the original mortgage, or the full amount due under the terms of an executed workout agreement or modification to the original mortgage. Because the contractor can collect the full fee only when he collects the full monthly payment, there is an incentive to bring delinquent accounts current and to keep the accounts in a current status.

GAO ANALYSIS OF HUD RESPONSE

Although HUD's response indicated that the Region III contractor was entitled to its basic fee only when a full monthly payment was collected, the original contract provisions relating to this and other payment fee issues were not clearly spelled out nor fully understood by the various HUD officials responsible for administering the contract. Because the original payment fee provisions were unclear and subject to varying interpretations, HUD on August 17, 1982, proposed a modification to the payment provisions. While the subsequent contract modification was an improvement, certain matters still remain undefined or unclear in the modification. To avoid the potential for contract disputes and to assist in the early development of an automated system for calculating the monthly payments due to the contractor, HUD needs to fully and clearly explain all matters relating to the payment fees and incorporate these clarifications in the Region III contract. Also,

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1/Generally, mortgagors are billed for monthly service charges in lieu of mortgage insurance premiums upon the assignment of a mortgage note to HUD.

similar steps should be taken for the nationwide contract if HUD decides to structure the payment provisions the same as it did for the Region III contract.

Based on our review of the payment fee structure for the Region III contract, we also believe potential problems could arise regarding contractor recommendations for workout agreements and foreclosure actions. Because the payment fee to the contractor is premised on the collection of a full monthly payment, it may be advantageous for the contractor to recommend lower monthly amounts and other terms as part of workout agreements. Also, because contractor recommendations for foreclosure actions stop the collection of service fees, there may be a disadvantage to the contractor to recommend such actions. HUD should closely monitor these issues as part of its approval of contractor recommendations. A recent HUD Office of Inspector General audit indicates that HUD's monitoring and approval of contractor recommendations in these two areas may need to be strengthened.

<u>Payment fee provisions for Region III and nationwide contracts need to be clarified</u>

The initial payment fee provisions of the Region III contract were unclear and subject to varying interpretations by HUD officials responsible for contract administration. The provisions stated that:

> "(a) In consideration of the services performed by [the contractor] in connection with this Contract, [the contractor] shall be paid a fee equal to 1/12 of 3/10 of 1% based on the average outstanding principal balance without taking into account delinquent payments or pre-payments for each monthly payment collected. [The contractor] will deduct its fees from the service charges collected for the Department, provided that the total fees retained by [the contractor] from each monthly collection of service charges shall not exceed 60% of the total potential monthly collection of service charges assuming a waiver of any such charge. In addition, [the contractor] will retain 1/2 of the amount of late charges assessed and collected pursuant to Article II 2(i) of this Contract."

Given the complicated language of the payment provisions, in June 1982 we contacted the Office of Finance and Accounting GTM for the contract to find out how the payment fee was to be computed. He explained that the fee structure provided that the contractor would receive a fee of 60 percent of the monthly service charges collected for each mortgage plus 50 percent of the late charges assessed and collected pursuant to Article II 2(i) of the contract. The Office of Finance and Accounting GTM also said that the contractor was not required to collect a full monthly payment in order to receive his full fee, and that he was only required to collect the entire service charge applicable to the mortgage. The GTM said that since the service charge is one of the first accounts that HUD applies payments to, there was no incentive to intensify collections beyond the collection of service charges.

In a subsequent discussion of this matter, also in June 1982, with the GTR from the Office of Multifamily Financing and Preservation and the GTM from the Office of Multifamily Housing Management and Occupancy, the Housing GTR stated that his understanding of the fee structure was the same as that of the GTM from the Office of Finance and Accounting. However, the Housing GTM disagreed with their interpretation and stated that the contractor collects his full fee only when he collects the full monthly payment due under the terms of the original mortgage, or the full amount due under the terms of an executed workout agreement or modification to the original mortgage. The Housing GTM said because the contractor can collect the full fee only when he collects the full monthly payment, there is an incentive to bring delinquent accounts current and to keep the accounts in a current status. Also, we discussed with HUD officials the fact that the contract did not clearly spell out how the application of Federal funds for interest reduction and rent supplement payments were to be treated in calculating the payment fee--particularly for workout arrangements which generally set forth lower monthly payments than called for under the original terms of the mortgage.

Because of the vagueness of the original contract provisions, on August 17, 1982, HUD transmitted to the Region III contractor a modification to the original contract payment provision. The two-page modification describes in greater detail how payments to the contractor are to be calculated. The modification specifies that a full monthly payment as provided for under the original terms of the mortgage, or as provided for under an approved and executed workout or modification to the original mortgage is required to enable the contractor to collect his fee. The modification further states that the application of Federal funds received from rent supplement and interest reduction payments were to be included in calculating the full monthly payment requirement. The modification also provides that in the case of partial payments for a given month that no fee would be paid unless the remaining balance of the partial payment is paid in full the following month.

Also, provisions were incorporated for the payment of fees to the contractor as a result of lump-sum monies received through workout agreements, mortgage modifications, and transfers of physical assets, when initiated and negotiated by the contractor and approved by HUD. In calculating a fee for these lump-sum collections, the contract allows the contractor to collect the typical 60-percent monthly service charge fee for each monthly payment that is comprised within the lump-sum collection. The contract states that lump-sum collections are to be computed against the mortgage payment required; except in the case of a modification or a transfer of physical assets when the lump-sum collection is to be calculated against the scheduled monthly payment under the original provisions of the mortgage. On August 27, 1982, the Region III contractor executed the modification indicating that the modification in no way changed the amount conceptually due under the original contemplated negotiated terms of the contract.

While the modification provision of the Region III contract improved the clarity of the original payment provisions, it still leaves several matters undefined or unclear. The modification, among other things, does not clearly explain how HUD will perform the calculations for partial payments and the requirement that the deficit be brought current in the following month. It does not discuss how fee computations will be made as a result of the contractor bringing current delinquencies resulting from a series of no monthly payments nor how this computation, according to HUD officials, differs from that allowed for partial payments. Also, the contract modification does not indicate how credits resulting from payments above the required monthly payment amount can be carried over in subsequent months for fee computation purposes. Finally, the contract modification appears to make a distinction which HUD officials told us is not intended in how fee computations will be calculated for lump-sum monies received through a workout arrangement as opposed to a mortgage modification or transfer of physical assets. Because of the complex fee structure, we believe these matters need to be clearly explained, committed to writing, and incorporated in the Region III contract.

We believe further clarification of the payment provisions is needed to avoid the potential for contract disputes and to assist HUD and the contractor in the early development of the automated system for calculating the monthly payments due to the contractor. Regarding the latter issue, HUD to date has been manually auditing the payments due to the Region III contractor. To accomplish this, HUD has devoted one staff person to audit the payments, interact with the contractor, and to accumulate certain data for evaluation purposes. The staff person estimated that she spends about 70 percent of her time auditing the fees due the contractor on the collection of payments for 144 mortgages in Region III. In discussing the staff intensive efforts HUD is devoting to auditing payments, the Office of Finance and Accounting GTM told us that the contractor will be required to develop an automated system to calculate fee payments that it is entitled to receive each month. He said before the system is implemented, however, HUD will test the system to ensure it produces accurate results. The Accounting GTM stated that he did not believe it would be difficult to develop a system to compute the monthly fees, but said that he could not be absolutely sure at this time. Also, the Accounting GTM did not know the status of the Region III contractor's efforts in developing the automated system that is required.

If HUD intends to use the same type of payment fee structure for the nationwide contract, similar steps should be taken to ensure the payment provisions are clearly explained and incorporated in the contract.

<u>Contractor recommendations for workout agreements and foreclosure actions should be monitored</u>

Based on our analysis of the fee structure, we believe HUD will need to closely monitor the contractor's recommendations for workout agreements and initiation of foreclosure actions. Since the fee structure is premised on the contractor collecting a full monthly payment, it may be to the contractor's advantage in negotiating workout arrangements to recommend lower monthly payment amounts and other terms that are more lenient than may be justified and that are not in the best financial interests of the Federal Government. Also, since foreclosure action automatically stops collections and fees to the contractor, it may not be advantageous to the contractor to recommend such action. The only apparent incentive for the contractor to recommend foreclosure actions is in order to reduce the servicing costs associated with the mortgage. Questions also arise concerning the manner by which Federal subsidy payments are treated in the calculation of the contractor's monthly fee. Because workout agreements generally provide for a lower monthly payment requirement, the Federal subsidy payments may in some cases cover the entire workout payment required and entitle the contractor to a fee without receiving any payment from the project owner.

HUD is responsible for reviewing and approving contractor recommendations regarding workout agreements and foreclosure actions to ensure that the Government's interests are protected. However, based on a recent audit 1/ by HUD's Office of Inspector General, as well as HUD internal studies, it appears that HUD may need to act on strengthening its review and approval capabilities.

In an October 20, 1982, Office of Inspector General report on the effectiveness of workout agreements administered by the Boston, Massachusetts and Hartford, Connecticut area offices, the Office of Inspector General reported that its audit disclosed such weaknesses as (1) delays in making the initial decision to workout or recommend foreclosure, (2) inadequate fiscal planning in developing a long-range mortgage reinstatement program, and (3) insufficient monitoring of workout agreements. The Office of Inspector General said these conditions have resulted in HUD granting defaulted mortgagors generous relief measures for prolonged periods without adequate demonstration of owners' cooperativeness and ability to reinstate the mortgage. These prolonged and sometimes unwarranted periods of workout deferred the ultimate decision to modify the

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1/"Multifamily Workout Agreements for Secretary-Held Mortgages," 83-TS-111-0001, Oct. 20, 1982.

mortgage or the initiation of foreclosure proceedings which, in turn, delayed the eventual collection of the mortgage loan or reduction of the loss by early foreclosure. Housing, in responding to the report, cited several actions it had underway, including its plans to contract out the loan servicing and accounting function for HUD-held mortgages, that are designed to strengthen the effectiveness of workout agreements. The Office of Inspector General recommended that there was still a need for HUD to establish additional criteria and standards and to issue further instructions for the loan servicers and/or the contractor to follow in evaluating the adequacy of reinstatement plans.

Earlier, in a June 18, 1982, memorandum concerning HUD policy for projects with HUD-held mortgages, the General Deputy Assistant Secretary-Deputy Federal Housing Commissioner stated that one of the greatest shortcomings in the implementation of past policies has stemmed from the length of time projects have been permitted to remain in default status. He cited HUD's unwillingness in the past to foreclose on projects where owners were unwilling or unable to address problems on a timely basis as contributing to this problem. The General Deputy Assistant Secretary said that, in the future, no workouts or modifications were to be approved unless they are shown to be a better alternative than foreclosure. The memorandum also took cognizance of the need to designate staff within each office to be proficiently trained in the areas of workout and modification analysis. The General Deputy Assistant Secretary said that having one or two "experts" in each office will greatly increase the quality and effectiveness of the workouts and modifications into which HUD enters.

CONCLUSIONS

Because the original payment provisions of the Region III contract were unclear and subject to varying interpretations, HUD in August 1982, had to issue a modification to the contract. While the modification was an improvement, certain matters still remain undefined or unclear. To avoid the potential for contract disputes and to assist in the early development of the automated system for calculating the monthly payment fees due the contractor, HUD needs to fully explain all matters on payment fees and incorporate these in the Region III contract. Also, similar steps should be taken for the nationwide contract if HUD intends to retain the same payment fee structure. Based on our review of the fee structure for the Region III contract, we believe potential problems could arise regarding contractor recommendations for workout agreements and foreclosure actions. HUD will need to closely monitor these issues as part of its approval of contractor recommendations to ensure that they are in the best interest of the Government. To improve its ability in this area, HUD should implement the recommendations made by its Office of Inspector General in an October 20, 1982, audit report on the need to establish additional criteria and standards for workout agreements. HUD should also take the steps outlined in the General Deputy Assistant

Secretary for Housing's June 18, 1982, memorandum on the need to improve staff expertise.

RECOMMENDATIONS TO THE SECRETARY, HUD

We recommend that the Secretary of HUD direct that:

--The Region III contract be further modified to make clear the payment provisions regarding partial payments, bringing delinquencies current resulting from a series of no monthly payments, carrying credits resulting from overpayments to subsequent months, and how fees will be computed for lump-sum payments collected through workout agreements. Also, similar steps for the proposed nationwide contract should be taken if HUD decides to retain the Region III payment provisions.

--Contractor recommendations for workout agreements and foreclosure actions be closely monitored. To assist in strengthening HUD's approval of contractor recommendations, HUD should implement the recommendations in the Office of Inspector General's report of October 20, 1982, and take the action outlined in the June 18, 1982, policy memorandum for designating staff in each office to become proficient in areas of workout and modification analysis.

AGENCY COMMENTS

HUD said that it would meet with us to resolve those payment fee provisions that we believe need further clarification. HUD also said that it intends, subject to budget authorization allowing for sufficient travel funds, to closely monitor the contractor's recommendations for workout agreements and foreclosure actions as recommended.

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