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STATEMENT OF
JOHN H. LUKE, ASSOCIATE DIRECTOR
HOUSING AND COMMUNITY DEVELOPMENT PROGRAMS
U.S. GENERAL ACCOUNTING OFFICE
BEFORE THE
SUBCOMMITTEE ON HOUSING AND CONSUMER INTERESTS
SELECT COMMITTEE ON AGING
U.S. HOUSE OF REPRESENTATIVES
ON
SELECTION PROCESS FOR LOANS
FOR SECTION 202 HOUSING FOR
THE ELDERLY AND HANDICAPPED



Mr. Chairman and Members of the Subcommittee:

We are here today to report on our review of the process used by the U.S. Department of Housing and Urban Development in 1983 to select borrowers to receive low-interest, direct loans for elderly and handicapped housing under section 202 of the Housing Act of 1959.

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Mr. Chairman, this review was conducted in response to your letter of April 10, 1984, in which you referred to us complaints received regarding the new project selection process initiated in 1983 for the section 202 program. Specifically, you asked us (1) to give you assistance in determining whether the selection system now in place is one that is conducive to the efficient selection of project sponsors on a merit basis, and (2) to look into allegations, of which you were aware, that project selections had been based upon political considerations rather than merit. As regards these allegations, further discussion with your office indicated that they dealt exclusively with the Chicago regional office and particularly the State of Ohio.

Senator Metzenbaum also wrote us on May 17, 1984, asking us to look into constituent allegations of improprieties in the section 202 selection process in the State of Ohio. He expressed concern with the "extraordinary discretion" provided to the HUD Regional Administrator in the new process and made special note of the fact that a large number of the Ohio projects had been funded from the Secretary's discretionary fund and that one building contractor was involved in many of these Ohio projects.

Our testimony is based on our review of the 1983 selection process in HUD's Chicago, Denver, and Fort Worth regions. We interviewed personnel involved in the selection process and examined records relating to the process in field offices, regional offices, and HUD Headquarters. Extensive work was

performed in the field office of the State of Ohio. Specifically, we analyzed files and records on selected Ohio projects and conducted numerous interviews with project applicants and their consultants, mortgage bankers, building contractors, and others involved in section 202 housing development.

In summary, we found that changes made in the selection process in 1983 tended to shift the decision-making responsibility away from the field office to the regional office. Prior to 1983, HUD field offices evaluated, scored, and recommended projects for selection through the regional office to HUD Headquarters. Field office scores and recommendations were rarely altered by the region or HUD Headquarters. In contrast, the new process allowed HUD regional administrators to alter ratings assigned to project applications by field offices and, subsequently, recommend projects for selections to the Assistant Secretary for Housing.

Although field office project scores are based upon somewhat subjective criteria, judgements are nonetheless well documented. The rescoring of projects and selection recommendations performed in 1983 at those regional offices we visited, were based upon limited project information, were undocumented, and were not based upon written criteria. Yet the score changes made in these regions substantially altered the rankings among some projects and likely affected the projects selected by the Assistant Secretary for Housing.

In general, we believe that when HUD reduced the influence of staff work upon the decision-making process and did not require justification for changes made in evaluations at the regional level, it created the perception and/or possibility that projects were selected for reasons other than merit. For the 1984 selection, process HUD is requiring some documentation of score changes. We have not assessed the impact of this change.

While we have no basis for concluding that the projects selected under the 1983 process are less worthy than others not selected, we did discover a number of apparent regulatory and procedural violations among the projects selected in Ohio and we will discuss these in detail in our testimony today.

Background

Under section 202 of the Housing Act of 1959, the federal government, through HUD, makes long-term direct loans to eligible private, non-profit project sponsors to use in developing housing that is specifically designed to meet the needs of the low-income elderly and handicapped.

Non-profit sponsors compete annually for section 202 funding which is allocated to individual field offices. In 1983, the total loan amount authorized was approximately \$634 million and was used to fund the construction of about 14,000

units with an average loan amount per unit of more than \$44,000. Applications are solicited once a year, usually in the spring, and the awards are announced in September. Approximately one of five project proposals are actually selected for funding. HUD field offices receive the applications, review and rate them against four specific ranking criteria, assigning points to sponsor experience, financial capability, project location, and cost containment. Non-profit sponsors usually work with a development team consisting of a housing consultant, architect, attorney, contractor, and perhaps a management firm.

Prior to 1983, field office project rankings and selection recommendations were forwarded to Headquarters through the regional offices. Selections were made by the Assistant Secretary for Housing, but scores were seldom changed and field office recommendations generally determined selections. In addition to the funds allocated to each field office, a portion of section 202 funding is retained each year by HUD Headquarters. In 1981, this "discretionary fund" was limited by Congress to 15 percent of section 202 obligations. These funds also were limited to specified purposes such as satisfying urgent needs and funding projects required by litigation. This discretionary fund is used to select projects from a "back-up" list consisting of all eligible projects recommended by the regions but not funded because of insufficient field office fund allocations.

In early 1983 as part of a general enhancement of the role of the regional administrator, HUD revised its selection criteria to reduce from a total of 100 points to 90 points the maximum scores which field offices could assign to individual applications. The remaining 10 points were made available to Regional Administrators to assign to projects based upon their assessment of a fifth criteria--the projects' "overall feasibility." These points could be assigned without written documentation. In addition, field office project scores on the other four ranking criteria could be reduced or increased by a total of 5 points without written justification.

EVALUATION OF THE SELECTION PROCESS

Our review of the 1983 selection process in three regional offices indicates that the new process has reduced accountability and in turn limits the Department's ability to explain or defend its decisions. Field office staff generally prepared documentation to support scores assigned to project applications, including any scoring adjustments made in the field office. But at the regional level no documentation was provided in 1983 for changes in project scores. Regional office staff involved in reviewing field office determinations generally had much less direct knowledge of the projects under consideration. The information provided for their use in reviewing applications in our view, was inadequate to make substantive judgments

regarding project "feasibility" or other ranking criteria, because this information was limited to individual scores, project location, number of units, sponsor name, and a checklist related to each scoring category. Project applications used by field offices and their technical evaluations are not forwarded. Yet, in all three regions, score changes at the regional office altered the field office rankings of applications and could have resulted in the selection of projects that would not have been selected based upon the original rankings. Those selected were generally the top ranked projects from each field office after regional score changes.

In the Chicago region, a special selection committee was formed to review the field office rankings. This committee maintained no records of its selection process and committee members had difficulty remembering the procedures used during their evaluation. They could not remember any discussions on particular projects for which scores had been changed. After conducting several interviews with committee members, it became clear that applications had been parceled out to individual members to review and that these individuals made changes in project scores, with little or no interaction with other members.

Committee members changed many ratings, both reducing scores assigned by field offices and adding points to other scores, using up to the 10 discretionary points allowed for

"overall feasibility" of a project. For example, the top ranked project from one field office had its score lowered substantially and was not recommended for selection. The 16th ranked metropolitan project from that office was given 15 additional points to rank second and then was one of two metropolitan area applications that the regional office recommended for selection.

In contrast to the Chicago Region, the Denver and Fort Worth regional administrators adjusted scores and made selection recommendations themselves. They relied primarily on the general score information provided by the field office but also obtained additional information as necessary from field office technical staff. However, no documentation of score changes was kept. In Denver, the regional administrator adjusted the scores of 5 of the 11 metropolitan area applications. The 8th, 9th, and 10th ranked projects scores were increased to rank 2nd, 4th, and 5th respectively and then recommended for selection. None of these projects would likely have been recommended for selection under the original field office ranking. All eight projects, (both metropolitan and non-metropolitan) recommended for selection by the regional administrator had their scores adjusted upward. In the Dallas field office, the regional administrator adjusted the scores of all 12 applications and recommended one which otherwise probably would not have been selected.

These examples illustrate the significant influence of the regional office under this new process and the absence of any documentation of selection decisions.

HUD staff and others we interviewed stated that under the 1983 process, field office staff cannot explain why projects were not selected or why project scores were adjusted. This may undermine the section 202 program by discouraging sponsors from applying. This could occur because non-profit sponsors, who often find it difficult to raise the money needed to prepare plans and applications for projects, will not want to waste their time and resources if they cannot learn why their projects were rejected and do not know how to improve their next application.

In 1983 HUD provided no criteria for regional offices' use in assigning points for overall feasibility except that they were to consider all pertinent factors including the ranking factors used by the field offices and any other factors bearing on the likely success or failure of a project. HUD made changes in the 1984 selection process to address certain of the deficiencies observed in 1983. HUD is now requiring documentation when scores are adjusted. Its 1984 instructions also suggest some factors for consideration in adding points for overall feasibility. But most of these factors are already considered by field offices in evaluating applications and assigning project scores. Thus the 1984 procedures continue to allow

administrators to review field office decisions but add a requirement for documentation of score changes. Notwithstanding these added requirements, we do not feel that the new procedures adequately address the full extent of the problem. As noted earlier, the documents forwarded from field offices to regional administrators do not contain enough information on the five ranking criteria to support informed judgements. As a result, the regional review process continues to be based upon limited project information.

Discretionary fund

Based on our interviews and study of the selection process, we are also concerned that the retention of funds for projects at Headquarters has led to the appearance of favoritism and exertion of influence in project selection. We found the same lack of documentation regarding the discretionary fund as we did with the regional selections. While it is clearly necessary for Headquarters to retain some funds for contingencies, such as change orders for projects funded in earlier years, for meeting special needs and for settling litigation, the discretionary fund held at Headquarters should be subject to an explicit set of standards and procedures established to govern selection of projects. Procedures should include the documentation of rationale for these selections and in particular address

instances where higher rated projects are not selected. The following comments deal with a number of projects funded from the discretionary fund.

ALLEGED IMPROPRIETIES

In accordance with your request, we examined allegations concerning improprieties in the selection process in Ohio. To do so we examined the Ohio selections and found five instances in which selected projects appeared to violate program regulations and project eligibility requirements. Actions of some people and corporations involved with four of these projects also involve potential violations of some Federal criminal laws.

Such violations can undermine the process by raising questions as to whether the Department is demonstrating necessary fairness and impartiality in meeting its fiduciary responsibilities to the public. In the course of examining projects selected in Ohio, we found three distinct types of violations. Five projects and nearly \$11 million in funding were involved. The problems were:

- an identity of interest between a non-profit sponsor and a construction firm (such relationships are prohibited by HUD regulations);

- the sale of a project site by a builder to the non-profit sponsor (also prohibited by HUD's, handbook evaluation procedures); and
- the selection of a project sponsor who appeared to lack adequate financial qualifications (in violation of HUD handbook evaluation procedures).

These projects were selected in two ways. Four projects were selected from the back-up list out of the Secretary's discretionary fund, and one was rejected by the HUD field office as ineligible but funded anyway by order from HUD Headquarters.

Identity of interest problems

We found four projects in Ohio in which one individual controlled both the construction contractor and the non-profit foundation developing these projects. This kind of relationship between sponsor and builder is prohibited by HUD regulations to discourage the creation of sponsors by builders. [See 24 CFR 277.1(c) and 885.5 (definitions of borrower and sponsor) and HUD Handbook 4571.1 Rev. 2, Para. 2-7.] Three of these projects were selected in 1983 from the Secretary's discretionary fund. They were not the highest ranked projects on the regional "back-up list." Headquarters officials who administer the section 202 program nationally had no knowledge of why these projects were selected over other higher ranked projects from

the regions. They said that selections from the discretionary fund were made personally by the Assistant Secretary for Housing. The fourth project was selected from the discretionary fund in 1982. After GAO notified HUD of this identity of interest problem, HUD has notified the sponsor that the builder for the 1983 projects was not acceptable and that they should wait until the GAO review was completed before selecting a new construction contractor. Funding on the 1982 project, which was under construction, was halted for several weeks pending a ruling by GAO on whether the contracting office would be held liable for disbursing any further funds. GAO's preliminary ruling, dated September 27, 1984, allowed construction to resume as long as HUD withheld an amount equal to the builder's profit.

Sale of land by builder

In one of the four projects above, the building contractor also owned the land on which the project was to be built and sold this land to the sponsor. Such sales are prohibited by HUD's section 202 handbook. [See HUD Handbook 4571.1 Rev. 2, para. 7-7e(4)] Section 202 program experts told us that no project where this occurred would be approved if it came to the attention of HUD officials in Washington. After we notified HUD of the problem this project was canceled altogether.

Lack of financial qualifications by sponsor

HUD Headquarters approved a church-related sponsor, even though its application had been rejected by the field office which warned that the applicant did not have the required financial strength to constitute a reasonable lending risk. The field office rejected the application because it found the sponsor did not have enough working capital to meet minimum requirements. A HUD headquarters official complained that there had been insufficient or inept financial analysis of the sponsor's financial data and accepted the application, reserving funds for it from the Secretary's discretionary funds. The field office noted in a subsequent review that the sponsor had been subject to mortgage foreclosure proceedings, had not paid real estate taxes on several parcels of land for several years, and had greater current liabilities than current assets. HUD Headquarters nevertheless funded the application from the discretionary fund. Subsequently, the field office learned that the sponsor had a large amount of unpaid withholding and employment taxes that were due to the Internal Revenue Service. After additional disagreements between the field office and Headquarters, HUD Headquarters instructed the field office to issue a conditional commitment, the second stage in funding the

project. We expressed our concern in writing to HUD regarding this problem, but HUD has not taken any action nor has it responded to our inquiry.

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In summary, Mr. Chairman we could find no evidence that the regional review and selection process has had any positive effect on the section 202 program. If HUD believes that some oversight of the field office selection process is desirable at the regional level, then HUD should establish clear standards for such oversight, provide that the regional office have adequate information with which to perform this oversight, and require full documentation for any regional office actions altering the decisions made in the field offices. Similar procedures and documentation requirements should also be applied to the Secretary's discretionary fund.

Finally, it is possible that some of the problems discovered in the course of our investigation may involve violations of Federal statutes dealing with conflict of interest, fraud, and conspiracy. Our sealed summary of these matters is being given to you today. Senator Metzenbaum is also being provided the same information. This sealed information will also be referred to the Federal Bureau of Investigation.