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REPORT BY THE U.S.

# General Accounting Office

GAO

## Action Being Taken To Correct Weaknesses In The Rehabilitation Loan Program

The Department of Housing and Urban Development services and accounts for defaulted rehabilitation loans valued at over \$53 million. In fiscal 1977 over \$2 million, or about 53 percent of the total amount due on the loans during the year, was not collected. This situation resulted from a lack of aggressive servicing by Department field offices and the use of a manual recordkeeping system which was incapable of accounting for an increasing volume of loans.

The Department's Rehabilitation Loan Program was the subject of congressional testimony on October 5, 1978. Department officials testified that GAO had properly identified the program's accounting and loan servicing problems and that the Department had taken or was taking corrective actions.



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

DIVISION OF FINANCIAL AND  
GENERAL MANAGEMENT STUDIES

B-114860

The Honorable Patricia Roberts Harris  
The Secretary of Housing  
and Urban Development

Dear Mrs. Harris:

This report discusses weaknesses in HUD's accounting and servicing of defaulted rehabilitation loans. Its contents have been discussed with responsible HUD officials, and as noted in the report, actions to correct the system's weaknesses have already been taken or are planned. In view of this, we recommend only that you ensure successful completion of efforts to correct the weaknesses.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report. It also requires a similar report to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget, and to the Chairmen of the Committees named above.

Sincerely yours,

A handwritten signature in black ink that reads "D. L. Scantlebury". The signature is written in a cursive style with a long horizontal flourish at the end.

D. L. Scantlebury  
Director



D I G E S T

The Department of Housing and Urban Development did not properly manage or account for defaulted rehabilitation loans valued at over \$53 million. As a result, the accounting records did not show the amounts due the Government on many defaulted loans, and over \$2 million, or about 53 percent of the amounts due in fiscal 1977, was not collected.

The Rehabilitation Loan Program provides direct low-cost loans to property owners for the rehabilitation of basically sound structures. Loans are initially serviced for the Department by the Federal National Mortgage Association. When a borrower becomes 6 months delinquent or is at least 3 months delinquent and misses 3 consecutive payments, the loan is returned to the Department for servicing.

At the time of our review, the Department had outstanding loans valued at almost \$334 million of which over \$53 million had already been returned to the Department and \$49 million was delinquent and may ultimately be returned. The Congress approved \$230 million for additional loans in October 1978.

The Rehabilitation Loan Program was the topic of congressional hearings on October 5, 1978. Department officials testified before the Manpower and Housing Subcommittee of the House Committee on Government Operations that GAO had correctly identified inadequacies and servicing problems in the rehabilitation loan accounting system.

## ACCOUNTING CONTROL WEAKNESSES

The Department did not maintain proper control over defaulted loans returned by the Federal National Mortgage Association. Some loans were delinquent for years, yet loan servicers had not recommended foreclosure or contacted the defaulted borrowers to arrange for loan payment.

Sizable differences existed between headquarters and field office inventories of loans on hand. For example, as of September 30, 1977, HUD's San Francisco field office had a loan valued at nearly \$240,000 which was not on the headquarters inventory while headquarters had over \$298,000 in loans which were not on the field office inventory. The Department had never reconciled the headquarters and field office records of defaulted rehabilitation loans. A reconciliation must be performed to determine the extent of the inventory differences. (See p. 5.)

The Department's manual recordkeeping system cannot adequately handle the volume of defaulted loans on hand. As a result, almost 2,300 loan records had not been promptly established and some records which had been established had not been properly posted. Since the records were not current, the accounting department did not provide periodic loan status reports to field offices to facilitate their loan servicing activities. A modern, automated accounting system is needed to handle the growing volume of defaulted loans. (See pp. 6-8.)

## FINANCIAL MANAGEMENT WEAKNESSES

The Department's loan servicing activity has been hampered by a general lack of management attention. Specifically GAO noted:

--The Department's interest computation method makes default profitable to borrowers and may contribute to the growing volume of loans being returned from the Federal National Mortgage Association. (See pp. 9 and 10.)

--The Department's managers have not paid enough attention to insuring that effective collection action is taken on defaulted loans. (See pp. 11-13.)

GAO also noted that the Department's field offices, due to staffing limitations and higher priority assignments, did not take effective collection action and seldom recommended foreclosure. As a result, only 46 percent of the defaulted loans receivable due in fiscal 1977 was actually collected. This has reduced the funds which would have been available to make new loans. (See p. 12.)

#### AGENCY ACTIONS

GAO suggested several actions to improve the Department's recordkeeping system and provide better controls over the Rehabilitation Loan Program. Department officials responded, in part, with the following actions that had been taken or were in process:

- Each area office was provided a detailed listing of the June 30, 1978, inventory of delinquent rehabilitation loans. HUD reconciled the records, completing the reconciliation in December 1978, and plans annual reconciliations in the future.
- The Department is reviewing the systems and techniques used by several other Federal agencies to control, service, and account for delinquent loans. In the interim, the accounting function for these loans has been transferred to the Philadelphia regional accounting division. All accounts are now current and a backlog of unestablished records or unrecorded collections and disbursements no longer exists.
- An intensive study is underway to substantially improve all aspects of the management and servicing of defaulted rehabilitation loans. This effort has very high priority in the Department. (See app. I.)

In testimony on October 5, 1978, before the Manpower and Housing Subcommittee of the House Committee on Government Operations, Department officials further agreed to:

- Charge a 4-percent late charge to deter late payments.
- Alter the Federal National Mortgage Association contract to permit more servicing by the Association.
- Provide additional staffing in both the Department's central office and field offices to operate the rehabilitation loan program.
- Consider a locality's delinquency rate when making future funding decisions.

#### CONCLUSIONS

Department officials have shown great interest in improving the program and have agreed to implement GAO's suggestions to correct the program's accounting and financial management problems. The Department has also established a special task force under the personal supervision of the Department's Under Secretary to study all aspects of the program and recommend needed changes.

GAO noted that the Department has never developed and submitted the design of the accounting system for rehabilitation loans to the Comptroller General for approval.

#### RECOMMENDATIONS

Because of the significance of this program, GAO recommends that the Secretary of the Department of Housing and Urban Development direct

- the Department's Office of Finance and Accounting to develop and submit the design of the revised accounting system for rehabilitation loans to the Comptroller General for approval and

--the Department's Inspector General to review the suggestions of GAO and the task force and ensure that adequate system changes are implemented.



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ABBREVIATIONS

FNMA Federal National Mortgage Association

GAO General Accounting Office

HUD Department of Housing and Urban  
Development

## CHAPTER 1

### INTRODUCTION

The Rehabilitation Loan Program, created by Section 312 of the Housing Act of 1964, as amended (and extended through September 30, 1979, by the Housing and Community Development Act of 1977) authorizes the Department of Housing and Urban Development (HUD) to make direct low-cost loans to property owners for the rehabilitation of single and multifamily housing and nonresidential property. To qualify for a loan the property must be located in certain designated areas. The purpose of the program is to prevent the unnecessary demolition of basically sound structures by providing funds to repair and improve the property so it complies with local housing and building codes.

Borrowers can receive loans up to \$27,000 for each dwelling unit. These loans can be repaid over 20 years at a 3-percent interest rate. Loan payments are, in turn, used to finance new loans. Believing that the program has proved to be a valuable tool in combating blight and in assisting in community revitalization, HUD has requested that the program be extended for 1 year beyond its current expiration date of September 30, 1979. In May 1978 about 460 cities were participating in the program.

As of September 30, 1977, HUD had nearly \$334 million outstanding in rehabilitation loans. HUD made approximately \$85 million in loans during fiscal 1977--the highest annual level of funding in the program's history. HUD planned to make another \$80 million in loans during fiscal 1978. On October 18, 1978, the Congress approved \$230 million for additional rehabilitation loans.

Under normal conditions, HUD does not get involved in the detailed administration of the program. Property owners request and receive loans through local government housing and community development agencies and make loan payments to servicing agents acting for the Federal National Mortgage Association (FNMA). HUD has contracted with FNMA to service the loans for a fixed monthly fee.

When a borrower becomes 6 months delinquent or is 3 months delinquent and misses three consecutive monthly payments, the loan is considered in default under the terms of the contract, and FNMA returns it to HUD. The responsibility for accounting for these returned loans now lies with HUD's Philadelphia regional accounting office. Before transferring the responsibility to Philadelphia, the

defaulted loans were handled under a manual recordkeeping system maintained by HUD's accounting division in Washington, D.C.

As of September 30, 1977, HUD was servicing 7,245 defaulted loans with an unpaid principal balance totaling about \$53.3 million, or about 16 percent of the dollar value of all active rehabilitation loans. During fiscal 1977, FNMA returned to HUD 881 loans valued at about \$7 million. At the time of our review, FNMA was servicing about 5,500 delinquent loans valued at about \$49 million which may ultimately be returned to HUD.

On October 5, 1978, HUD officials testified on the program before the Manpower and Housing Subcommittee of the House Committee on Government Operations. In the testimony, HUD officials agreed to correct many of the accounting and servicing problems which we had brought to their attention and which are described in this report.

#### SCOPE OF REVIEW

We reviewed HUD's policies and procedures in accounting for and servicing defaulted rehabilitation loans. We also examined HUD's accounting system for controlling and recording the collection and disbursement of loan funds and evaluated its loan collection system in operation. This review was carried out at HUD headquarters in Washington, D.C., and at HUD field offices in Philadelphia, St. Louis, and San Francisco.

## CHAPTER 2

### HUD'S SYSTEM TO ACCOUNT FOR DEFAULTED REHABILITATION LOANS NEEDS IMPROVEMENT AND MODERNIZATION

HUD's manual recordkeeping system for defaulted rehabilitation loans is inadequate to handle the current workload and lacks the necessary controls to ensure that an accurate inventory of loans on hand is maintained. Defaulted rehabilitation loans are part of HUD's accounting system for rehabilitation loans overall; the design of that system has not been approved by the Comptroller General.

While HUD's manual recordkeeping system for defaulted rehabilitation loans may have been adequate when installed in 1971, it is totally inadequate now because five clerks are attempting to control and service over 7,000 loans. As a result, HUD's inventory of defaulted rehabilitation loans on hand is incomplete and inaccurate. For example, as of September 30, 1977, the accounting staff had not established official records for 2,297 defaulted loans and had not posted approximately \$1 million in collections to individual borrowers' accounts.

#### NEED FOR INVENTORY CONTROLS OVER DEFAULTED LOANS

HUD had not established the necessary controls to ensure that an accurate inventory was being maintained of defaulted rehabilitation loans on hand. As a result, HUD's inventory was incomplete and inaccurate and included numerous uncollectible loans which should have been written off. Without an accurate inventory, management cannot determine whether effective action is being taken to collect loans outstanding or whether loans are written off as uncollectible when appropriate.

As a minimum, an adequate system of controls should include

- maintaining an up-to-date master listing of all defaulted loans on hand so that management knows the current status of all loans,
- annually reconciling headquarters and field office inventories to keep the inventory complete and accurate, and

--establishing a central HUD receiving point for all defaulted loans returned by FNMA so that no loans can get into the system without both headquarters and the responsible field office knowing it.

Master listing of defaulted loans not current

Prior to transferring the accounting function to Philadelphia, the program accounting division was responsible for maintaining the official loan records on each defaulted rehabilitation loan. The division also maintained a master listing, by HUD region, of all defaulted loans. As of April 1978, the master listing for the San Francisco region had not been updated in over a year to include loans returned by FNMA or exclude loans that had been foreclosed, paid off, or written off. The master listings for the other nine HUD regions were in a similar condition. Consequently, HUD management did not know how many defaulted loans actually existed.

In March 1978, we requested that the Director, Office of Finance and Accounting, furnish us with certain statistics, including the number of defaulted rehabilitation loans on hand at the end of fiscal 1977 and the total unpaid principal balance on these loans.

Personnel of the program accounting division worked for several weeks to prepare an inventory which showed 7,245 defaulted rehabilitation loans on hand as of September 30, 1977, and valued at about \$47 million. However, that figure is low because HUD was unable to place any value on 888 of these loans. HUD officials claim that the data necessary to determine the unpaid balance owed on the loans when returned by FNMA was not furnished by FNMA, as required. We have estimated the value of all 7,245 loans at about \$53.5 million.

While we did not verify the accuracy of the inventory, we did find several loans on HUD field office inventories that were not on the headquarters inventory and several loans still on the headquarters inventory that had been written off as uncollectible by the field offices. The fact that an inventory reconciliation between headquarters and field office records had never been made also caused us to question the inventory's accuracy.

Failure to reconcile  
records of defaulted loans

HUD had never reconciled headquarters records of defaulted loans on hand with field office records. As a result, the number of defaulted rehabilitation loans being serviced by HUD field offices disagreed with headquarters records of the same loans as of September 30, 1977.

As part of our review, we reconciled the defaulted loan records of HUD's San Francisco field office with those of the program accounting division at the headquarters office. Headquarters office records indicated 267 defaulted loans in the San Francisco area; San Francisco office records showed only 260.

The San Francisco office's records had one loan with an unpaid principal balance of \$239,900; headquarters records showed no such loan. The loan had been made in 1968 and, as of May 1978, no payment had been made. According to field office files, no debt collection action had been initiated on this loan.

Headquarters' records showed eight loans with a combined unpaid principal balance of \$298,430. None of the loans was on the San Francisco office's records and, as described below, none was being serviced by the field office as valid loan receivables.

--The field office had no loan record files to support the validity of two of the loans with an unpaid principal balance of \$48,900.

--Documentation was available in the field office to support the validity of three of the loans with a total unpaid principal balance of \$24,720. However, through clerical error, the data was misfiled, the loan records were never established, and no collection action was ever attempted.

--Documentation available in the field office showed that the other three loans with a total unpaid principal balance of \$224,810, had been foreclosed by a senior lien holder or acquired by HUD between May 1973 and October 1974.

Differences also existed between headquarters defaulted loan records and those in St. Louis. For example, HUD's St. Louis office records showed 69 defaulted loans while the headquarters records for St. Louis showed 74 loans. The St. Louis records included two loans that were not on the

headquarters records while the headquarters office had seven loans that were not on the St. Louis records. These discrepancies were the result of neither headquarters nor the field offices notifying the other or taking action when these loans were returned by FNMA, paid in full, or written off as uncollectible.

We believe that HUD could improve its collection and servicing activities by establishing and maintaining an accurate record of defaulted loans on hand.

No central HUD receiving  
point for defaulted loans

Until June 1977 FNMA returned defaulted loans directly to the HUD field office in which the rehabilitated property was located. It was the field office's responsibility to forward documentation to the headquarters office so that the official loan record could be established. In some instances, the headquarters office had no record of loans that had been returned. FNMA is now required to return all loans to the office of insured and direct loan origination at departmental headquarters in Washington, D.C. Headquarters then sends the servicing records to the responsible HUD field office and the accounting records to the HUD Philadelphia field office.

This change will help to achieve more accurate records of defaulted loans. However, the problems in maintaining accurate records will not be completely solved until the records of the headquarters office and the field offices are periodically reconciled and the discrepancies identified by the reconciliation are resolved.

For HUD management to effectively control resources invested in the rehabilitation loan program, it must have accurate records of defaulted loans returned from FNMA. Without accurate records, management cannot be sure that adequate action is being taken to collect these loans.

SYSTEM OF ACCOUNTING FOR DEFAULTED  
LOANS SHOULD BE AUTOMATED

HUD's manual system to account for defaulted rehabilitation loans did not provide prompt and accurate recording of loan payments. Over 30 percent of the individual loan records at the headquarters office had not been adequately established as of September 1977. As a result, HUD had not established the amount of principal and interest owed to the Government for these loans.

Official rehabilitation loan records were maintained in the program accounting division at the headquarters office by clerks who manually computed interest due and posted all accounting transactions to each individual loan record card. In May 1971, four clerks maintained 167 loan records. In September 1977, five clerks were responsible for 7,245 loan records.

As of September 30, 1977, when the accounting function moved to Philadelphia, the program accounting division had established an official loan record for 4,948 of the 7,245 loans on hand. (See table below.) Documentation was available to establish 1,409 of the 2,297 unestablished records. However, as discussed earlier, documentation was missing at HUD headquarters for the remaining 888 loans.

The director of the office of finance and accounting said that although individual loan records were not promptly established, the loans, as well as subsequent collections and disbursements, were recorded in the general ledger. He also said that accountability was established and maintained, although not on an individual loan basis, and that the data needed to establish individual loan records was not always furnished to headquarters at the time the loan was returned by FNMA. According to this official, as the following schedule shows, one reason for the failure to establish individual loan records is the ever-increasing volume of work.

Increasing Volume of Delinquent Loans  
and Percentage of Delinquent Loan Records  
Not Established in Headquarters (note a)

<u>Date counted</u>	<u>Total loans</u>	<u>Loan records not established</u>	<u>Percentage of total loans not established</u>	<u>Estimated dollar value of all loans (millions)</u>
May 1971	167	Unknown	Unknown	\$ 1.5
October 1972	823	Unknown	Unknown	8.1
December 1973	2,184	525	24.0	17.3
August 1974	2,883	689	23.9	20.6
April 1975	3,708	1,265	34.1	25.0
October 1976	5,229	1,328	25.4	37.4
September 1977	7,245	2,297	31.7	53.5
January 1978	7,867	2,945	37.4	56.7

a/Data furnished by HUD's office of finance and accounting except for estimated dollar value of all loans which is a GAO projection based on the average dollar value of the loans that were established.

We believe that a modern automated recordkeeping system would help solve many of HUD's collection and loan servicing problems by facilitating the establishment and maintenance of an accurate record of defaulted loans on hand.

#### AGENCY ACTIONS

We suggested several actions to Department officials to improve accounting and provide better controls over the Rehabilitation Loan Program. In responding to the suggestions (see app. I) the Department officials said the following actions have been taken or are in process:

- Each HUD field office has been provided a detailed listing of the June 30, 1978, inventory of defaulted rehabilitation loans. An initial inventory reconciliation was scheduled to be completed by September 30, 1978, and annual reconciliations are to be made thereafter. (A HUD official told us the reconciliation was completed in December 1978.)
- HUD is reviewing the systems and techniques used by several other Federal agencies to control, service, and account for delinquent loans. In the interim, the accounting function for these loans has been transferred to HUD's Philadelphia regional accounting division. All accounts are now current and a backlog of unestablished records or unrecorded collections and disbursements no longer exists.

#### CONCLUSIONS

The Department's corrective actions should lead to an accurate inventory of defaulted rehabilitation loans currently on hand. In addition, HUD plans to revise the current accounting system and is considering the complete mechanization of the recordkeeping function. In short, the Department is considering system design changes which will provide long-range solutions to the problems created by the manual process.

#### RECOMMENDATION

In view of the current thinking of the Department in moving toward system design changes, we recommend that the Secretary of Housing and Urban Development direct the Department's office of finance and accounting to develop and submit the design of the revised accounting system for collecting and servicing rehabilitation loans to the Comptroller General for approval.

### CHAPTER 3

#### FINANCIAL MANAGEMENT OF

#### DEFAULTED LOANS NEEDS STRENGTHENING

HUD's loan servicing activity has been hampered by a general lack of attention by management. Specifically, we noted:

- HUD's interest computation method makes default profitable to borrowers and may contribute to the growing volume of loans being returned by FNMA.
- HUD's managers have not paid enough attention to insuring that effective collection action is taken on defaulted loans.
- HUD did not assess late payment charges, therefore, borrowers had little incentive to make timely payments.
- HUD has not properly maintained or administered borrowers' escrow funds entrusted to it.
- HUD's policies and procedures are inadequate to ensure that borrowers are treated consistently by different field offices.

By not taking more aggressive collection action, HUD has lost funds which could have been used to finance new loans.

#### INTEREST POLICY MAY RESULT IN INCREASED VOLUME OF DEFAULTED LOANS

HUD charges a lower effective rate of interest on defaulted loans than FNMA charges on current loans. This creates an incentive for borrowers to default so they may obtain the lower effective interest rate. Prior to October 1973, HUD could return a loan to FNMA when the borrower resumed normal payments. Since that time, HUD changed its interest policy and now must retain these returned loans to maturity even if the borrower becomes current in making payments. We believe that this situation has contributed to the increased volume of defaulted loans being returned to HUD.

HUD's method of allocating monthly loan payment amounts between principal and interest on defaulted loans is different than the method used on most interest-bearing debts owed to the United States, including rehabilitation loans serviced by FNMA. HUD's method lowers the effective interest

rate from 3.0 to 2.3 percent upon default, resulting in a 31.5 percent savings in interest actually paid by the borrower. Since some rehabilitation loans amount to over \$250,000, the inducement to default could be considerable.

The Comptroller General and the Attorney General have issued joint regulations generally requiring application of the "U.S. Rule" with respect to interest-bearing debts owed to the United States. Those regulations state, in part:

"When a debt is paid in installments and interest is collected, the installment payments will first be applied to the payment of accrued interest and then to principal, in accordance with the so-called 'U.S. Rule,' unless a different rule is prescribed by statute, contract, or regulation." (4 C.F.R. Section 102.10).

The "U.S. Rule" is followed by FNMA in servicing rehabilitation loans. However, HUD, under the provisions of the law, issued the following regulation on the method to be used to apply payments received.

"Where, in connection with a section 312 account serviced by HUD, collection is made under a payment plan approved by the Assistant Secretary for Housing Management, amounts received shall not be applied according to the so called 'U.S. Rule' as prescribed in Section 102.10 of the joint regulations of the General Accounting Office and the Department of Justice (4 C.F.R. 102.10). In such instances, amounts received shall be applied first to satisfy the principal of the debt. Subsequent payments shall be applied to the interest obligation, calculated on the basis of declining principal balances without charging interest on interest balances." (24 C.F.R. Section 445.1)

Borrowers aware of HUD's regulation can withhold payments intentionally, thereby becoming delinquent so that FNMA will return the loan to HUD. They will then be charged a lower effective interest rate.

MANAGEMENT SHOULD GIVE MORE  
ATTENTION TO THE COLLECTION  
OF DEFAULTED LOANS

HUD management has been relatively inattentive to the lack of effectiveness of collection efforts on defaulted rehabilitation loans. One reason for this is that HUD's recordkeeping system for defaulted loans does not provide readily available and informative data by which HUD management can evaluate the collection activity. It took the program accounting division several weeks to compile the following data which we requested:

- Loans on hand at the end of fiscal 1977.
- Loans returned to HUD by FNMA during fiscal 1977.
- Loans paid off during fiscal 1977.
- Loans written off as uncollectible during fiscal 1977.
- Loans foreclosed during fiscal 1977.
- Annual collections for fiscal 1977.
- Amounts which should have been collected according to loan agreements during fiscal 1977.

The program accounting division was unable to compile data on

- loans that became current during fiscal 1977 and
- loans delinquent over 60 days at the end of fiscal 1977.

We believe that ready access to the above data on a periodic basis is essential to any meaningful analysis of HUD's collection activity.

As stated in chapter 1, FNMA services rehabilitation loans for HUD as long as the borrowers remain current in their payments. Under the terms of the contract between FNMA and HUD, FNMA is precluded from engaging in any aggressive collection actions such as phoning or visiting delinquent borrowers or threatening legal action for nonpayment. FNMA is allowed to send routine delinquency notices to borrowers. When a borrower becomes 6 months delinquent or is 3 months delinquent and misses three consecutive monthly

payments, the defaulted loan is returned to HUD for further collection action.

Collection efforts on defaulted rehabilitation loans have been delegated to field office personnel whose primary responsibility is servicing defaulted home improvement loans. The collection of defaulted home improvement loans often gets greater emphasis, so rehabilitation loan servicing is done only as time permits. Loan servicers seldom

- contacted defaulted borrowers to work out modified payment agreements,
- recommended foreclosure action when further collection appeared futile, or
- recommended writing off uncollectible loans even when the pledged collateral became worthless.

HUD headquarters has not established standardized collection policies and procedures. Each field or regional office, therefore, has been forced to establish its own collection procedures which have met with varying degrees of success. An analysis of the data compiled for GAO by the program accounting division disclosed a wide variance in success among HUD regions in collecting loan payments due during fiscal 1977. HUD's Seattle region had the highest success rate (73 percent) while the Boston region had the lowest (only 14 percent). Nationwide, HUD's success rate was about 46 percent, based on an average of only 3.2 collections per loan per year. Differences of this magnitude indicate that significant collection problems exist within HUD even though some regions have apparently been able to implement relatively successful collection practices and procedures. Those successful practices should be made known to all regions.

During our review at HUD's St. Louis field office, we found that 97 percent of the loans were delinquent 60 days or more. Also, regular payments were being received on only 5 of 66 loans and of those 5, only 2 loans were current. Local HUD officials said they were making few collection efforts because they lacked sufficient time and staff. They further believed that the collection activity which did take place was a waste of time considering the results obtained. They also complained about the lack of management information provided by HUD headquarters, stating that useful data should include, for all defaulted loans, the balances due, the number of payments delinquent, and the collateral securing the loans.

During our review at HUD's Philadelphia field office, we found that about 65 percent of the loans were delinquent over 60 days, as shown below:

<u>No. of months delinquent</u>	<u>Delinquent loans</u>	
	<u>Number</u>	<u>Percentage</u>
0 to 2	175	35%
3 to 6	61	12
7 to 12	72	14
13 to 24	88	18
25 to 36	52	10
37 to 48	25	5
over 48	<u>31</u>	<u>6</u>
Total over 2 months	329	65
Total all loans on hand	<u>504</u>	<u>100%</u>

Local HUD officials stated that HUD headquarters could be more helpful by providing better collection guidelines and instructions, especially for handling problem cases.

We believe that HUD management should give more attention to evaluating the effectiveness of the collection activity on defaulted loans. We further believe that HUD management should consider nationwide implementation of any collection practices that have proved successful in particular regions.

LATE PAYMENT CHARGES SHOULD BE USED TO ENCOURAGE PAYMENT

In the past, a borrower has had little incentive to make prompt monthly loan payments because HUD did not assess late payment charges. In the "Administration of Insured Home Mortgages Handbook," HUD states:

"The late charge is intended to reimburse the mortgagee for additional expenses incurred in its collection activity and as a collection tool, to encourage or motivate the mortgagor to make payments in a timely manner."

Although HUD recognizes the value of late payment charges for insured home mortgages, it did not use the practice on defaulted rehabilitation loans which are usually secured by first or second mortgages on the property. HUD has elected to waive penalties and late charges on the basis that these items would place an additional financial burden on the borrower.

We believe that assessing late payment charges would provide an incentive for borrowers to promptly repay their loans and would be a lesser financial burden than the additional interest which accrues on a delinquent unpaid principal balance.

ESCROW ACCOUNTS NOT PROPERLY  
MAINTAINED OR ADMINISTERED

HUD did not properly maintain or administer borrowers' escrow accounts. Escrow accounts had not been analyzed or monthly escrow payments adjusted to show changes in property tax rates or hazard insurance premiums. Property taxes were not always paid even though HUD had previously collected the money from the borrowers to pay them.

HUD requires that escrow accounts be established on all rehabilitation loans over \$10,000. The borrower is required to make monthly payments to the escrow account to assure that sufficient funds will be available to pay property taxes and hazard insurance premiums when due. It is the escrow agent's responsibility to pay these items on behalf of the borrowers, analyze the accounts at least annually, and adjust the monthly payment amount to compensate for changes in tax or premium rates.

Prior to transferring the accounting function to Philadelphia, the program accounting division maintained the escrow accounting records on defaulted rehabilitation loans returned to HUD. However, the HUD field offices are responsible for obtaining borrowers' property tax bills, and the tax payments are made by HUD regional offices. The program accounting division claimed that responsibility for adjusting escrow payment amounts rested with the field offices. Field office personnel claimed that a proper analysis cannot be made unless the borrower's escrow balance is known. They further claim that the division did not make this data available so they seldom bothered to adjust escrow payments.

When escrow requirements were not reviewed, some borrowers were required to pay excessive monthly payments. Proper review of escrow balances would have revealed those borrowers whose taxes and insurance had declined or borrowers who were paying the escrow bills themselves. This situation resulted, for those borrowers, in excessive escrow balances that could have been better used to reduce the unpaid balance on their loans. Conversely, other borrowers whose taxes and insurance had increased were continuing to make monthly payments at the lower rate, resulting in insufficient escrow balances to cover the bills that came due. In this situation, HUD advanced

funds to the borrowers to make up the differences owed. HUD does not charge interest on these "cash advances," but they must be repaid before any loan payments are applied to principal.

We analyzed 33 loans requiring escrow accounts and found that, based on actual expenditures, 15 loans required excessive monthly escrow deposits while 13 required insufficient escrow deposits. In only 5 instances did the required monthly escrow deposit appear accurate. We also found that 19 of the 33 loans had outstanding interest-free cash advances ranging from \$72 to \$6,086.

#### Improper administration of escrow accounts

Property taxes were not always paid by HUD even though escrow accounts were maintained. HUD also paid some taxes late and erroneously charged the penalties to the borrowers.

In HUD's St. Louis field office, we reviewed rehabilitation loans on which HUD held the first mortgage to determine the current real estate tax status of the property. The results were as follows:

- 1976 taxes were paid by borrowers in five instances even though escrow accounts were required on four of the five loans. In no instance was the escrow balance on hand sufficient to pay the tax.
- 1976 taxes were paid by HUD in six instances. In one instance, the tax was paid late and the penalty was charged to the borrower. In four other instances, the escrow balance was less than the tax due.
- 1976 taxes were not paid at all in five instances. In each case, the escrow balance was less than the tax due.
- 1973 through 1976 taxes were not paid in two instances, even though in one instance, the escrow balance was sufficient to pay the tax owed. The city is filing suit for nonpayment in both cases.
- In three instances, the borrower lost the property to the city for nonpayment of delinquent taxes. The city took these properties between 1975 and 1976, but the loans were not written off by HUD. In all three instances, the escrow balance was less than the taxes owed.

As described below, one of the cases listed above illustrates why escrow accounts should be analyzed and adjusted annually.

A loan in the amount of \$8,550 was returned to HUD by FNMA in January 1969. The loan agreement called for monthly escrow payments of \$69 for property taxes. As of August 1977, nearly \$2,079 had accumulated in the escrow account. The city of St. Louis' tax records disclosed that the annual tax bill on this property was less than \$300 and that 1973, 1974, 1975, and 1976 taxes, totaling nearly \$1,088, had not been paid by HUD on behalf of the borrower.

Had HUD officials analyzed this borrower's escrow account, they would have realized that an excessive escrow balance had built up because taxes had not been paid. They also would have realized that the monthly escrow payments could be reduced from \$69 to \$25 and that almost \$1,000 could be diverted from the escrow account to reduce the unpaid principal balance. Not only was this borrower required to pay an excessive amount of escrow, but he is also in danger of losing his property to the city for nonpayment of taxes.

We believe that a modern, automated recordkeeping system could generate the data necessary for an annual analysis of each borrower's escrow account. We further believe that HUD should do a better job of administering the borrower's escrow accounts by paying property taxes when due and by not passing late payment penalties on to the borrowers when HUD is at fault.

#### FINANCIAL MANAGEMENT POLICIES AND PROCEDURES NEED TO BE IMPROVED

HUD headquarters has not provided adequate guidance and procedures to field offices for servicing defaulted loans. HUD's loan servicing handbook is obsolete and has never been updated to reflect policy changes which have affected the loan collection activity. Some HUD field offices established their own local procedures for servicing loans, resulting in inconsistent treatment of borrowers in different parts of the country. HUD headquarters has been in the process of revising the loan servicing handbook for over 4 years. As of June 15, 1978, only a handwritten draft existed which had not been reviewed by HUD officials.

The Rehabilitation Loan Servicing Handbook was published in September 1970 with the latest revision issued in August 1973. The instructions are very general and do not provide adequate guidance on actions to be taken systematically when

borrowers fail to pay. In addition, some of the instructions no longer apply because of changes in HUD policy. For example, HUD's decision to change its interest policy in October 1973 (see pp. 9 and 10) made the following handbook instructions obsolete:

- Applying payment amounts to interest and then to loan principal.
- Accruing interest on cash advanced by HUD to pay taxes and insurance.
- Returning loans to FNMA when the borrower resumes consistent loan payments.

Because of the lack of formal procedures, borrowers were treated inconsistently by different field offices. The San Francisco field office, for example, had established effective procedures for paying property taxes; the Seattle field office had established effective collection procedures. However, other field offices' procedures for the same actions appeared questionable. For example, Philadelphia field office personnel were authorizing maintenance and repair on defaulted borrowers' properties and were making interest-free loans to finance this work. We do not believe that this program was meant to establish perpetually open-ended loans.

We believe that financial management policies and procedures relating to defaulted loan servicing need to be formulated by HUD headquarters and consistently implemented by HUD field offices so that all borrowers are treated fairly but firmly. We further believe that HUD should evaluate local practices currently in use so that successful methods of loan servicing could be identified and applied agencywide.

#### AGENCY ACTIONS

GAO suggested several actions to Department officials to provide better financial management of the program. In responding to the suggestions (see app. I) Department officials said that the following actions had been taken or were in process:

- An amendment to the Department's codified regulations requiring payments be applied first to interest and the balance to principal, in accordance with the U.S. Rule, has been drafted and is being reviewed within the Department.

- An intensive study aimed at substantially improving all aspects of the management and servicing of defaulted rehabilitation loans is underway. This effort has a very high priority in HUD.
- Penalties for late payment of property taxes will not be passed on to the borrower when HUD is at fault.
- By September 30, 1978, proper escrow account balances were to be established for each borrower. However, as of February 2, 1979, the balances were still in the process of being established.
- The Rehabilitation Loan Servicing Handbook is being rewritten and updated and is on an accelerated timetable for issuance.
- Appropriate instructions for improved loan servicing methods will be issued immediately.

In testimony of October 5, 1978, before the Manpower and Housing Subcommittee of the House Committee on Government Operations, HUD officials additionally agreed to:

- Charge a 4-percent late charge to deter late payments.
- Alter the FNMA contract to permit more servicing by FNMA.
- Provide additional staffing in both the Department's central office and field offices to operate the rehabilitation loan program.
- Consider a locality's delinquency rate when making future funding decisions.

#### CONCLUSIONS

The Department's actions should lead to substantial improvements in the financial management of the rehabilitation loan program. With the anticipated future growth in the program, the Secretary should arrange for the monitoring of efforts to improve the program to ensure that needed changes are completed as quickly as possible.

## RECOMMENDATION

Therefore, we recommend that the Secretary of Housing and Urban Development direct the HUD Inspector General to review the actions taken pursuant to our recommendations and to those of the task force to ensure that adequate system changes are implemented.



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, D.C. 20410

OFFICE OF THE ASSISTANT SECRETARY  
FOR ADMINISTRATION

September 1, 1978

IN REPLY REFER TO:  
AF

Mr. Donald Scantlebury  
Director, Financial and General  
Management Studies Division  
U.S. General Accounting Office  
Washington, D. C. 20548

Dear Mr. Scantlebury:

At our recent exit conference with GAO representatives to discuss the findings and recommendations in their audit of the Section 312 Rehabilitation Loan Program, we described actions that have already been taken by HUD that will satisfy most of the recommendations. Mr. Cronin asked that I document these actions to you so that they may be included in your audit report. Actions and comments follow for each recommendation discussed.

1. Recommendation: Establish needed financial management controls to insure that loan inventories are reconciled at least annually and that a current master listing of loans on hand is maintained.

Action Taken: Delinquent loan records for all accounts on hand in the Office of Finance and Accounting have been established and all payments received have been recorded. A detailed listing of the inventory as of June 30, 1978, has been provided to each area office for reconciliation. This initial reconciliation will ensure that all delinquent loans are accounted for and that the Headquarters payment data is in agreement with field records. A detail reconciliation of each loan record card, including escrow analysis, will be completed by September 30, 1978. An aging report will also be provided as of September 30, 1978 to the field and each month thereafter. A complete reconciliation of all delinquent loans will be effected at least annually thereafter.

2. Recommendation: Consider establishing a modern, automated recordkeeping system for defaulted loans to alleviate the backlog of unestablished records and unposted collections and disbursements.

Action Taken: Members of my staff have visited the Farmers Home Administration, Veterans Administration and Federal National Mortgage Association to review their systems and techniques to control, service and account for delinquent loans. It may be possible for us to use one of their software packages to bring in-house, or depending on available time, have our delinquent accounts serviced by one of them on a reimbursable basis. In the interim, we have decentralized the maintenance of accounting records for these delinquent loans to the Philadelphia

Regional Accounting Division. The accounts have now been brought current. There is no longer a backlog of unestablished records or unrecorded collections and disbursements.

3. Recommendation: Reevaluate the decision to deviate from using the U.S. Rule on both the defaulted Rehabilitation Loan program in view of the possible incentive to default created by this policy, and the unfair treatment to borrowers who have remained current in paying their debts.

Action Taken: An amendment in 24 CFR 445 to apply payments first to interest and the balance to principal, in accordance with the U.S. Rule, has been drafted and placed in Departmental clearance.

4. Recommendation: Direct management officials to give more attention to evaluating the effectiveness of the collection activity on defaulted loans.

Action Taken: Top management in HUD is well aware of the need to give more attention to the effectiveness of collection efforts on defaulted rehabilitation loans. This is currently under intensive study by HUD staff, looking to substantial improvements in all aspects of the management and servicing problem as soon as possible. This effort has very high priority in the Department, and is personally being monitored by the Under Secretary.

5. Recommendation: Consider the feasibility of assessing late payment charges as a means of motivating borrowers to make payments in a timely manner.

Comments: The present late charge penalty of one percent per payment per calendar month would not be an effective deterrent to tardy payment. Therefore, the Department is studying alternatives of late payment charges (e.g., a 4% penalty) along with its review of various mechanized systems for the process.

6. Recommendation: Instruct the Program Accounting Division to work with the field offices in performing an annual analysis of each borrower's escrow account and cease the practice of passing penalties for late payment or property taxes to the borrower when HUD is at fault.

Action Taken: The Department has taken immediate action to correct these internal accounting problems. By September 30, 1978, the inventory of delinquent loan accounts will have been reconciled with field records and proper escrow account balances established for each borrower. Thereafter, these account balances will be maintained on a current basis. Account information will be furnished to the field offices monthly and there will be an annual review and reconciliation made. Late payment charges will not be passed on to the borrower when HUD is at fault.

7. Recommendation: Direct management officials to formulate needed financial management policies and procedures for servicing defaulted rehabilitation loans.

Action Taken: Policy and procedure to assure consistent and equal treatment of all defaulted borrowers is in Handbook 7376.1, Section 312, Rehabilitation Loan Servicing Handbook. This handbook is presently being rewritten and updated, and is on an accelerated timetable for issuance. Interim instructions will be issued.

8. Recommendation: Direct management officials to evaluate local practices and procedures currently in use in order to identify successful loan servicing methods which could be applied nationwide.

Action Taken: Appropriate instructions for improved loan servicing methods will be issued immediately.

In light of the above actions that HUD has taken to correct the major weaknesses and deficiencies in both managing and accounting for the Section 312 Delinquent Loan Accounts, I suggest the title of this proposed audit report be changed to "Servicing Delinquent Section 312 Rehabilitation Loans."

Sincerely,

  
T. J. O'Connor  
Director  
Office of Finance  
and Accounting

(90625)

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