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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Honorable Bob Traxler House Of Representatives

Better Cash Management Needed In HUD's Section 312 Housing Rehabilitation Loan Program

The Department of Housing and Urban Development's Section 312 Rehabilitation Program offers homeowners loans at only 3 percent interest. Department procedures require local housing agencies to deposit Federal loan funds in escrow accounts until needed to pay contractors for completed work.

In some instances local agencies benefit by investing the funds held in escrow. The Department of the Treasury incurs unnecessary interest costs because it borrows money at rates higher than 3 percent much sooner than required.

An alternative financing technique, possibly a letter of credit, should improve cash management of the program by timing cash advances more closely to actual disbursement needs.



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

IN REPLY
REFER TO:

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-198228

The Honorable Bob Traxler
House of Representatives

Dear Mr. Traxler:

You asked that we review the Department of Housing and Urban Development's (HUD's) cash management procedures for administering the rehabilitation loan program authorized by section 312 of the Housing Act of 1964. As agreed with your office, our review concentrated on identifying (1) whether the Federal Government incurred unnecessary interest costs and (2) whether local housing agencies benefited financially because Federal funds were released prematurely.

The results of our review are summarized below and discussed in more detail in the appendix.

A key feature of the Section 312 Program is that homeowners who get such loans are charged only 3 percent interest. HUD procedures require that Federal funds advanced for such loans usually be in the hands of local housing agencies on or before the date of loan settlement with homeowners. Shortly after settlement, the local agencies deposit the funds in escrow accounts and homeowners begin repaying the loans. However, in some cases actual rehabilitation of housing units and disbursement of loan funds occur several months later.

The five local agencies we visited are targeted to receive about \$6 million of the \$230 million in section 312 loan funds available during fiscal year 1980. Four of the five local agencies we visited had large 312 loan escrow balances on deposit for extended periods before the funds were needed to pay rehabilitation contractors. The four agencies had benefited financially by investing the escrow balances. The Department of the Treasury had incurred unnecessary interest costs because money for 312 loans was borrowed at rates higher than 3 percent much sooner than required to meet actual rehabilitation disbursements.

HUD has taken some corrective action by instituting modified loan procedures for large section 312 loans which more closely time cash advances with payments to contractors. HUD

B-198228

Secretaries of the Departments of HUD and the Treasury; the Director, Office of Management and Budget; and other interested parties 30 days after the issue date, unless you publicly release its contents earlier.

Sincerely yours,

A handwritten signature in black ink that reads "Henry Eschwege". The signature is written in a cursive style with a large, prominent initial "H".

Henry Eschwege
Director

C o n t e n t s

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ABBREVIATIONS

CDBG	Community Development Block Grant
HUD	Department of Housing and Urban Development
LPA	Local Public Agency

BETTER CASH MANAGEMENT NEEDED INHUD's SECTION 312 HOUSING REHABILITATION LOAN PROGRAMINTRODUCTION

Representative Bob Traxler of the House Committee on Appropriations asked us to determine whether the Government had incurred unnecessary interest costs because section 312 loan funds were released prematurely. He also asked whether local public agencies (LPAs) had benefited financially by holding large 312 escrow balances for extended periods before paying rehabilitation contractors.

Section 312 of the Housing Act of 1964, as amended (Public Law 88-560), established the 312 loan program under the Department of Housing and Urban Development (HUD). The program provides direct low-interest, long-term loans to property owners in approved areas. The loans are used to finance or refinance rehabilitation needed to bring residential, nonresidential, or mixed-use properties into or above conformity with local codes and applicable urban renewal property rehabilitation standards.

Section 312 single-family home loans are limited to \$27,000 per dwelling unit; nonresidential property loans are limited to \$100,000. Loans can be repaid over 20 years at a 3 percent interest rate. Low- and moderate-income families receive priority based on several factors, including the ability to repay the loans and the extent of needed rehabilitation.

From 1964 through March 1979, the aggregate value of section 312 rehabilitation loans had reached \$528 million. During fiscal year 1980 the program will have about \$230 million available from appropriations and loan repayments.

LPAs are responsible for loan processing leading up to and following settlement with section 312 borrowers. LPAs make initial contact with property owners about the availability of section 312 loans. LPAs also inspect property, determine borrower eligibility, prepare rehabilitation cost estimates, help obtain bids and select contractors, and process loan applications.

After loans have been approved, LPAs request funds from HUD to arrive in time for loan settlements, which are similar to those for purchasing a home. When loans are settled, Treasury Department checks are endorsed by the borrowers and deposited in rehabilitation loan escrow accounts held by LPAs.

Lebanon County LPA held small escrow balances, primarily because it did not have nearly as many section 312 loans as the other four. The following table shows the semiannual status of the section 312 escrow accounts for the five LPAs.

The above table includes settled loans that have been closed out. If these were deducted from the totals, the percentage of section 312 funds still in escrow, based on active loans, would be even larger.

The city of Baltimore, which has participated in the program since 1966, has maintained consistently large 312 escrow balances. The city's end-of-month 312 escrow balance averaged \$1.1 million between July 1977 and June 1979. For the 24-month period, monthly deposits of settled 312 loans received from HUD averaged over \$226,000. This figure was more than the monthly disbursements to rehabilitation contractors and others, which averaged only about \$181,000. Baltimore's maximum monthly disbursements occurred in May 1978 when \$311,000 was paid out. However, May's end-of-month 312 escrow balance still remained high at \$1.2 million.

Examples of problems which permit loan balances to remain in escrow for extended periods follow.

- A Philadelphia homeowner settled a \$4,500 loan in May 1978. At settlement, \$94 was paid for real estate taxes and fire insurance. In October 1978 a decision was made to cancel the loan since a larger one was needed and the property had to be rebid. The loan was still not canceled as of November 1979. Thus, the LPA held \$4,406 in escrow for about 1-1/2 years.
- A Baltimore homeowner settled a \$9,650 loan in July 1977. Homeowner settlement costs amounted to \$252.25. The contractor was authorized to proceed on July 28, 1977. However, the contractor withdrew on September 14, 1977, because of a dispute with the homeowner. A replacement contractor was authorized to proceed on October 31, 1977. Thus, the LPA had \$9,397.75 in escrow for an additional 3 months because of the first contractor's withdrawal.
- A Philadelphia homeowner settled a \$2,750 loan in January 1979. At settlement the homeowner paid \$7.50 for mortgage recording. Two days after settlement, the contractor said he could not maintain his original bid price. In August 1979 the homeowner was provided with a contractor list and advised to get an acceptable bidder. The loan was still open as of November 1979. Thus, the LPA had \$2,742.50 in escrow for about 11 months.

LPAs obtaining financial benefits

HUD regulations presently do not address whether LPAs are permitted to deposit 312 loan funds in interest-bearing accounts. Without such restrictions, the three large LPAs-- Baltimore, Philadelphia, and Washington, D.C.--deposited 312 loan funds in interest-bearing accounts. The 312 funds were commingled with other revenues from city operations and Federal and State grant funds in a single general or corporate bank account.

The cities earn interest on the commingled account and invest some of the funds. For example, an official in Baltimore's Bureau of Accounting Operations said that about \$100 million of the corporate account is invested yearly. The LPAs' specific financial benefit from using 312 funds could not be determined because of the commingling of funds.

The other two LPAs--Allegheny and Lebanon Counties, Pennsylvania--deposited 312 loan funds in non-interest-bearing accounts. However, the Allegheny County LPA withdrew \$250,000 from the 312 escrow account in July 1979 to purchase a certificate of deposit yielding 9.9 percent annual interest, with a maturity date of January 1980. This investment reduced the July end-of-month escrow balance from \$311,645 to \$61,645. Apparently, LPA officials were confident that the \$250,000 would not be needed to pay rehabilitation contractors until at least January 1980. The LPA's executive director told us that the interest of \$12,375 earned would be used to pay unplanned expenses of the 312 program or other programs administered by the agency. A deputy director in Pittsburgh's HUD area office told us that further investigation of the Allegheny County LPA's actions is planned.

Alternative funding procedure
seems appropriate

Uneconomical cash management of the 312 program results from the advanced funding to LPAs of most 312 loan amounts. An alternative funding procedure, possibly a letter of credit, seems appropriate.

Federal agencies have been using letters of credit to finance grant programs for a number of years. A variety of letters of credit are currently in use for Federal grant programs. The techniques differ primarily in the timing of withdrawals to pay program disbursements. During fiscal year 1979, 19,000 active letters of credit were used to disburse \$97.8 billion. The Treasury has estimated substantial savings of interest through these methods.

Also, HUD is investigating the feasibility of permitting LPAs to deposit 312 funds in interest-bearing accounts with the provision that all accrued interest be returned to the Treasury. Also, HUD has increased technical assistance to LPAs to improve contractor selection and payment.

We believe that cash management of the Section 312 Loan Program can be further improved. Perhaps HUD could expand the recently adopted modified loan settlement procedures to include 312 loans under the \$60,000 limitation. If the modified procedure is not feasible for full-scale application, HUD could consider adopting the letter of credit. In fact, many communities receiving 312 funding already have letter-of-credit mechanisms in place for HUD's Community Development Block Grant (CDBG) Program. HUD could institute procedures whereby LPAs pool information from all rehabilitation contractors entitled to payments within, for example, the next week. Letter-of-credit withdrawals would be made accordingly. Financing the 312 program by letter of credit will save the Treasury interest costs on the public debt and eliminate the LPAs' large 312 escrow balances.

OTHER OBSERVATIONS

Title I of the Housing and Community Development Act of 1974, as amended (42 U.S.C. 5301), established the CDBG Program. This program provides funds for community development activities designed to eliminate slums and blight, assist low- and moderate-income persons, and respond to urgent local needs. HUD funds many CDBGs by means of a letter of credit.

Over 1,500 localities throughout the United States have chosen to use some CDBG funds for property rehabilitation programs. Rehabilitation financial assistance is usually provided through direct grants, revolving loans, and subsidized private lending. Property owners use these funds to repair, weatherize, or make cosmetic changes to their properties.

CDBG's total budget for rehabilitation financing increased from \$232 million in fiscal year 1975 to \$431 million in fiscal year 1977. For fiscal year 1980 CDBG rehabilitation funds probably will exceed \$750 million. Of this amount, we estimate that communities will use about \$200 million for direct grants.

During the review, we observed that the letter of credit is being used improperly to finance CDBG rehabilitation direct grants. HUD permits LPAs to draw down the entire amount when the grant agreement is made with the owner rather than when cash is actually disbursed to rehabilitation contractors.

HUD officials told us that the financing technique adopted and other program changes would be incorporated in the new section 312 regulations and the revised loan processing handbook which should be issued by September 1980.

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