

CHAPTER 7. RISK-BASED MONITORING

- 7-1. **Purpose.** This chapter prescribes that risk based concepts and strategies be incorporated in all plans and procedures for monitoring. Since conditions change over time, management needs to determine if management controls continue to effectively address new or changed risks. This is done by on-going monitoring activities, separate evaluations or a combination of both, utilizing a risk-based approach.
- 7-2. **Policy.** The Department will maximize its use of available resources by incorporating risk management concepts and strategies in the conduct of all programs and activities. All policies and procedures for carrying out program oversight responsibilities will be consistent with risk-based monitoring strategies and guidance provided in this chapter.
- 7-3. **Overview of Risk-Based Monitoring.** The effectiveness of the Department's programs is largely dependent upon how well HUD policies and program requirements are carried out. Risk-based monitoring is a strategy to identify and target management attention and resources to program activities and participants that represent the greatest risk to program missions and are the most susceptible to fraud, waste, and mismanagement. It includes regular management and supervisory activities, and it also includes routine risk abatement actions employees take in performing their duties. It requires the application of risk management concepts and strategies in the conduct of all monitoring activities to ensure effective use of resources in managing program risks.

The risk-based monitoring process requires involvement by all management levels. The major steps for implementing risk-based monitoring include:

- A. Identifying program missions, goals, risks and monitoring objectives to determine what is to be monitored. The foundation for oversight activities will consist of appropriate management controls for achieving program mission and goals. This is largely accomplished through the Department's Management Control Program. Identified risks are analyzed, and monitoring objectives are set based on this analysis.
- B. Developing methods to risk rate participants, programs and functions, including assessing the Department's exposure to fraud, waste, and mismanagement. Some risks are specific to particular types of participants or programs. Criteria should be developed for establishing risk profiles. These risk profiles will also be effective in assessing the level of resources required to execute risk-based monitoring activities.
- C. Developing and communicating strategies and plans for oversight of identified risks. The oversight strategies for managing risk, as articulated in HUD directives and plans, address priority objectives to be achieved in areas such as:
 - Timely risk-based monitoring;
 - Current program monitoring guidance;

- Properly trained staff, and
 - Appropriate resource allocations for risk-based participant monitoring and program execution.
- D. Selecting programs/program participants for monitoring within available resources, based on monitoring objectives and risk profiles established by program areas.
- E. Assuring that effective and efficient risk-based monitoring activities are performed, including identifying whether follow-up corrective actions are necessary and the use of sanctions.
- F. Documenting the process and recording the rationale for choosing participants.

The risk-based monitoring process should be carried out in coordination with other Department management processes to ensure successful results in controlling fraud, waste, abuse and mismanagement. This includes recognizing the existence of these risks and the strategies for controlling them in budget requests, management plans and objectives, resource allocations, management reviews and performance reporting.

7-4. **Responsibilities.** Implementation of risk-based monitoring requires involvement by managers at all levels. Major roles and responsibilities are as follows:

- A. Primary Organization Heads (POHs) are responsible for implementation of risk management concepts and risk-based monitoring within all programs under their direction, including identifying program objectives and assessing risks, as part of the Management Control process. POHs should develop and implement viable oversight strategies and plans for managing program risks, optimizing their use of travel and staff resources. These strategies and plans should reflect consideration of past and present program risks, existing program guidance, resource allocations and training needs. POHs have final authority in determining how best to apply risk-based monitoring in their program areas.
- B. The Chief Financial Officer (CFO) is responsible for overseeing the Department-wide implementation of management control concepts in program operations and monitoring activities and for setting policies and guidelines for maintaining an effective risk management program within the Department. The CFO will provide technical assistance to POHs when necessary to assure risk management considerations are properly addressed. The CFO will monitor the progress of POHs in developing and implementing their risk management strategies, plans and priority objectives, including assessing the results of their risk-based monitoring efforts, as appropriate.
- C. Program Office Directors develop specific risk-based monitoring strategies including risk-based rating systems for program participants which must be approved by their

POH. These officials will oversee risk-based monitoring activities and make decisions on needed revisions to improve risk-based monitoring in their programs. They will report to POHs on the effectiveness of risk-based monitoring activities in their areas.

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7-5. **Identifying Program Risks and Setting Monitoring Objectives.**

- A. General. The overall objective of the risk-based monitoring process is to allocate a larger share of monitoring resources to those program functions posing the highest risk. To ensure adequate oversight, monitoring reviews and resources are to be adjusted through a risk weighing process that will determine both the entities and activities to be reviewed. This provides a rationale for why some functional areas or program participants are more closely monitored than others.

HUD program activities vary in the degree of risk involved in their administration. For example:

- Defaults are an inherent risk in loan activities;
- Contractor problems occur in rehabilitation projects; and
- Claims are an inherent risk in insurance activities.

Under the Department's Management Control Program, program managers try to minimize these program risks by using a number of different management control techniques. Examples include:

- Issuing regulations that establish eligibility;
- Reviewing required reports;
- Requiring insurance coverage for perils; and
- Requiring audits.

Nevertheless, risks still exist in these areas and the cost of the stringent controls needed to eliminate all risks are prohibitive and generally unacceptable to goal attainment. Therefore, in developing their programs and strategies for managing risks, program managers have to achieve a cost/benefit balance. For activities where strong controls are not possible, managers have to use effective risk-based monitoring to keep a closer watch on higher risk activities.

- B. Identifying program risks. The program mission, goals and risks identified and documented as part of the management control process provide the basis for setting monitoring objectives. Based on this information and any additional information obtained as a result of further research and analysis of problem areas, Management should determine which program activities present the greatest risk to the Department. Program directors should use their experience and professional judgment in prioritizing these risks. They should also consult with knowledgeable and experienced staff and

coordinate with the Office of the Chief Financial Officer to assure that all identified risks are considered.

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- C. Establishing monitoring objectives. Program directors will develop monitoring objectives for the prioritized risks that are critical. These objectives are designed to verify compliance with program requirements (i.e., achievement of the missions/goals) and to validate the accuracy of key quantitative data (e.g., performance indicators, financial reports, etc.) and the quality of the reported performance. Objectives should be related to meaningful performance measures.

If the program has not developed meaningful performance measures, monitoring becomes too subjective. This may result in relying too heavily on the monitoring process to see if rules are being followed without clearly evaluating if results are being achieved.

An example of establishing monitoring objectives follows:

- Program Area: Housing
- Mission: Provide decent, safe, and sanitary housing.
- Program Risk: Participants will fail to make required repairs for appropriate property preservation.
- Monitoring Objective: Assure the project has established a periodic inspection schedule for all units.

The discovery of new systemic weaknesses may require the addition of new monitoring objectives. If new monitoring objectives are added, they may replace existing objectives or procedures. Any objectives or procedures to be deleted should be selected based on a relatively low risk as shown by past monitoring reviews. When reevaluating these monitoring objectives, consideration should also be given to available resources to complete monitoring activities.

- D. Identifying program risks. The program mission, goals and risks identified and documented as part of the management control process provide the basis for setting monitoring objectives.
- E. Establishing monitoring objectives. Headquarters' and field program directors will develop monitoring objectives for the prioritized risks that are critical.

7-6. Developing Risk-Based Rating Systems for Program Participants

- A. Identifying Program Participant Red Flags. Program participant red flags are the criteria for assessing: (a) risk exposure to the Department; (b) the likelihood that a program participant has failed or refuses to comply with program requirements; or (c)

that the participant has performed unacceptably. Program directors should develop red flags that relate to overall program success, while other red flags should evaluate performance in a specific program activity. The structure of the rating systems should result in program participants who pose higher risks being subject to increased monitoring.

An important consideration in selecting red flags is ensuring that reporting systems are providing managers with necessary performance information regarding the participants. If reporting systems are inadequate, an interim rating system may be needed until reporting systems can be revised.

Examples of risks which should be considered in developing red flags include:

1. age of project;
2. types/mix of program activities;
3. amount of current/total funding expended and/or obligated;
4. physical condition of project;
5. management problems;
6. new management or key staff who are inexperienced or are likely to have performance problems;
7. performance indicators, such as reserve levels, claim rates, vacancy rates, jobs created, etc. (These can be very useful as long as uniform standards are set to distinguish poor performance from good performance.);
8. first time participants or activity;
9. time elapsed since last review;
10. contingency for local factors (economy, complaints, etc., determined by local staff); and
11. history of demonstrated lack of performance by program participants.

B. Monitoring low risk participants. Implementing risk-based monitoring need not result in the review of only high risk participants. Management should establish a process that also allows field staff to monitor a limited number of other than high risk participants. This can serve to validate the soundness of the rating criteria as well as possibly obtaining early warning of potential serious problems. In setting up this process, the following should be considered:

- Time set for monitoring lower risk participants should not represent too large a percentage of the total monitoring to be completed.
- Scheduling of these participants should be based on time elapsed from the last visit, or where remote monitoring shows negative changes in performance.
- Procedures should be flexible so that as-needed reviews are conducted.
- Visits should be coordinated, as possible, with other program participants to conserve resources and travel funds.

7-7. Developing and Communicating Strategies and Plans

- A. General. Each POH with program oversight responsibilities should develop risk management strategies for improving and managing appropriate controls over identified program risks. The results of this strategic planning process should be a coordinated set of plans and priority objectives for both Headquarters and field accomplishment. These oversight strategies for managing risk, as articulated in Headquarters and Field directives and plans, should address priority objectives to be achieved in areas such as:

- Timely risk-based participant monitoring;
- Current program and participant monitoring guidance;
- Properly trained staff; and
- Appropriate resource allocations for risk-based participant monitoring and program execution.

- B. Developing plans. Managers should analyze the results of their management control activities and develop viable strategies and action plans for managing the risks.

The fact that managers should establish, evaluate and report on management controls is obvious to managers implementing requirements of the Department's Management Control Program in their program areas. What is not as obvious, however, is the need for managers to devise strategies and to set priorities on how to best manage identified risks with available resources.

The management control program is, in effect, an early warning system for managers to determine and plan what needs to be done in Headquarters and the field to manage risks. These plans should contain specific objectives for both Headquarters and field staff which address capacity improvement needs, such as resource requirements and training, as well as program oversight priorities.

- C. Relationship to Business Operating Plan. The Business Operating Plan should serve as the principal vehicle for articulating the priority objectives for the field to complete in achieving the program strategies for managing risk. Headquarters' objectives should also be communicated to keep all levels aware of the overall risk management plan and strategy. Each POH should also provide specific guidance on monitoring priorities among programs within the purview of the POH.
- D. Allocation of Program Resources. In developing plans, consideration should be given to both staff levels and other program resources available and required to accomplish

objectives and implementation strategies. For example, if field staff resources are insufficient to accomplish all on-site monitoring required, consider using procurement funds to contract out selected on-site monitoring responsibilities. The strategy should address resource allocation decisions distinguishing between headquarters and field issues, where required. Such resource allocation decisions should stem directly from the budget process and include: staff complement, procurement funds, travel funds, training funds, etc. This decision process should not result in a categorical

determination that there are insufficient resources to execute the strategy. Rather, a program area should be creative in arriving at alternatives for achieving its plan.

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- E. Reassessments of strategy and plans. The POHs should periodically review progress in implementing their oversight plans, including the adequacy of resources to complete objectives and to achieve the overall risk management plan. The POHs should evaluate the effectiveness of the initial risk-based monitoring strategy, and determine whether modifications should be made to the initial approaches to achieve objectives. These modifications may result from changes in resource allocations due to budget decisions, revised program structures, etc. These modifications should be communicated to appropriate Headquarters and field staff.
- F. Training Needs. For risk-based monitoring activities to be effective, they must be conducted by well trained staff. Training should include basic program knowledge and use of monitoring procedures. Cross-training in other basic functions should be planned since monitoring staff will often review areas outside their specialty. Training should be developed and presented frequently enough to cover staff turnover. Consider providing skills training for conducting reviews (e.g., sampling, interviewing, etc.), fraud awareness/abuse, etc.
- G. Updating program guidance. The concept of risk-based monitoring should be included in all programmatic monitoring handbooks for all programs requiring monitoring. For new programs, the concept should be incorporated during the development phase. For existing programs, monitoring instructions must be reviewed and revised, as necessary, according to plans established by the POHs. All related guidance, e.g. notices and other communications should be consistent with risk-based monitoring requirements.

7-8. **Rating and Selecting Participants for Monitoring**

- A. Rating and ranking participants. A rating system should be developed so that the Department's field staff, as well as Headquarters offices with monitoring responsibilities, can risk rate each of their program participants. Based on these evaluations, staff may find it appropriate to revise existing monitoring strategies for a particular participant. For example, if a remotely monitored participant has declined in ratings from low to high, the field office would schedule the participant for on-site monitoring.
- B. Developing monitoring schedules. Once all participants have been risk rated, a participant monitoring schedule will be established. To the extent possible, such schedules should be completed prior to the start of the fiscal year. This information will be relevant in establishing the resource priorities within the Business Operating Plan. By having an updated risk profile of program participants prior to the budget cycle, the managers will be in a better position to negotiate that monitoring activities receive an appropriate share of available resources.

7-9. Conducting Monitoring Activities

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A. Monitoring Techniques. Headquarters program managers and field managers should consider using a range of techniques for risk-based monitoring activities. The following types are examples of the risk-based monitoring techniques that are available for use:

- On-site monitoring
- Audit activities
- Remote monitoring

1. On-site monitoring reviews are considered essential for high risk program participants and recommended for other participants, to the extent practical. Once participant monitoring objectives are established, on-site reviews should target critical areas and systemic problems. The scope of such reviews can include:

- A minimum review of each major activity, expanding the scope if problems become apparent;
- An in-depth review of program compliance based upon monitoring guidance requirements;
- A minimum review of all major activities, including a mandatory in-depth review of critical functions; or
- An in-depth review of high risk participants in areas where performance is inadequate, etc.

The overall success of the on-site review is dependent, to a great extent, on how well the efforts of the reviewers are managed. Effective management includes:

- Matching responsibilities with appropriate available personnel to efficiently achieve the best results;
- Organizing review documentation to ease review and ensure completion of the on-site procedures; and
- Creating a framework for timely review to ensure that documentation supports conclusions reached.

A written work program should be developed to use as a monitoring plan for guidance and control of an on-site review. The work program should begin with a brief statement of the intended objectives and provide a logical methodology to complete the objectives. Generally, such work programs should be developed from monitoring guidance as set forth in programmatic handbooks. Planning prior to an on-site visit will result in a more efficient and effective evaluation of a participant's performance.

Estimating the length of time to conduct each review and related travel costs is essential to the preparation of realistic on-site monitoring schedules. Field

office program directors should have discretion in preparing such schedules and revising them due to new information, such as declining participant performance, or other unanticipated events.

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2. Audit activities are defined as examinations undertaken by independent auditors, such as the Office of the Inspector General or other contracted parties, to evaluate a participant's program compliance and/or to perform an examination of a participant's financial condition or results of operations. Examinations under the Single Audit Act are an example of these types of activities. Generally, such activities are mandated within a particular program and the information obtained is utilized during the field's remote monitoring procedures.
3. Remote monitoring procedures are those activities, other than on-site monitoring, undertaken by Headquarters and field offices in monitoring program participants. Examples of remote monitoring activities include evaluating grantee performance reports, reviewing audited financial statements, evaluating interim project cost reports, etc. Remote monitoring should be used for all program participants, yet these procedures are especially critical for those participants where no on-site monitoring is performed.

Performance measures are tools used in remote monitoring that should be established as indicators of program performance or efficiency. Such measures are used to highlight trends in the overall performance of a program or to highlight declining performance of a particular participant. These measures are also used in assessing risk of program participants. Performance measures can be particularly effective in remote monitoring, which may lead to further on-site evaluation.

- B. Resource allocations. Resource allocations should include: staff complement, procurement funds, travel funds, training funds, etc. If there are insufficient resources to complete scheduled monitoring and additional resource requests are denied, staff should be creative in managing available resources for conducting monitoring activities. This decision process should not result in a categorical determination that there are insufficient resources to monitor program participants. Rather, consider alternatives

such as increasing types of remote monitoring activities, developing more sophisticated performance indicators, taking advantage of electronic technology to transmit information, adjust monitoring schedules, etc.

Some offices use independent monitoring staff while others do not. Management must consider the varying roles that monitors will fulfill and assess whether these roles would significantly affect their ability to monitor objectively. If an office does not use a separate monitoring staff, then management must provide clear and strong direction on production versus quality issues so that the monitoring staff's objectivity is not compromised.

- C. Reassessing monitoring schedules. Monitoring schedules will be revised due to reassessments of participants from monitoring activities, program resource reallocations, and other unforeseen events. It is essential that staff maintain an updated monitoring schedule to maximize the effectiveness and flexibility of field monitoring activities.
- D. Follow-up actions. For monitoring activities to be effective in reducing risk for the Department, an assessment must be made as to whether follow-up actions are required as a result of any identified problems, noncompliance or suspected weaknesses.
- E. Sanctions. Sanctions are an essential component of any effective monitoring process. There will be cases where participants fail or refuse to comply with recommended actions. Appropriate administrative or programmatic sanctions should be applied in these cases. Sanctions are used to establish credibility for enforcing the monitoring system.

7-10. Documenting Risk-Based Monitoring Process

- A. General. All program staff must document various parts of the risk-based monitoring process, for each program and activity. By using the monitoring process described above, documentation requirements can readily be satisfied since the process provides the basis and rationale for the decisions and actions taken.
- B. Guidance considerations. The following risk-based monitoring areas should be included in program handbooks and guidance:
- Rationale for risk-based monitoring of selected programs and participants;
 - Process for implementing risk-based monitoring activities, as previously outlined, within the program area including process for determining participant risks and rankings;
 - Clear monitoring steps and review standards for on-site reviews, including:
 - Documentation requirements (i.e., checklists, copies of key documents, inspection reports, etc.)
 - Technical requirements
 - Supervisory review
 - Reporting results to Departmental officials and participants
 - Flexible guidance for conducting on-site reviews, permitting field staff discretion in eliminating or reducing certain portions of on-site work, when justified. Clearly state which review instructions are mandatory, require supervisory approval to omit, or subject to the field reviewer's discretion to perform; and

- Guidance on how to impose administrative sanctions for a respective program area.

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C. Documentation requirements. All levels of management must document the determinations made during the various stages of the risk-based monitoring process. A review of the documentation should quickly identify:

- What program risks were considered;
- What participant risks were considered;
- How participant risks were scored for ranking purposes;
- How these results translated into monitoring plans and objectives;
- What results were achieved;
- How one year's experience leads to the next year's considerations and plans.

Changes in program area strategy and newly identified risks should be linked to any required changes in management plans.

7-11. **Reporting Deficiencies**

Deficiencies must be reported up the chain of command to those who can take appropriate corrective action. However, some critical weaknesses may transcend organizational divisions and must be resolved at an agency wide level.