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HOUSING PRESERVATION

Policies and Administrative Problems Increase Costs and Hinder Program Operations

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The Honorable Christopher S. Bond
Chairman
The Honorable Barbara A. Mikulski
Ranking Minority Member
Subcommittee on VA, HUD,
and Independent Agencies
Committee on Appropriations
United States Senate

The Honorable Jerry Lewis
Chairman
The Honorable Louis Stokes
Ranking Minority Member
Subcommittee on VA, HUD,
and Independent Agencies
Committee on Appropriations
House of Representatives

The Congress created the preservation program 10 years ago to keep existing multifamily housing affordable for lower-income households as the owners of several thousand federally insured multifamily properties were approaching eligibility to prepay (pay off) their mortgages. Prepayment would allow these owners to terminate the existing affordability restrictions, such as the limits on the income levels of residents and the rents that can be charged. The program, which offers incentives to owners and purchasers of federally insured multifamily properties who agree to maintain their properties for low-income occupancy, has been amended frequently. Currently, the financial incentives are provided through grants or loans and primarily cover a payment to (1) the existing owner for equity in the property—essentially an amount derived from the appraised value of the property less the unpaid principal balance on the loan insured by the Federal Housing Administration (FHA) and (2) the owner or purchaser to rehabilitate the property. The preservation program has proven to be costly and complex.

This report was prepared to comply with the requirements of House Conference Report 104-812, accompanying the fiscal year 1997 appropriations act for the Departments of Veterans Affairs, Housing and Urban Development (HUD), and Independent Agencies (P.L. 104-204), which requested a GAO study of the preservation program. As requested, we reviewed (1) the funding provided for preservation properties as

compared with the properties' values, (2) the levels of rehabilitation grants provided to properties compared with their physical needs, and (3) the administrative and other problems that have arisen under the program. In addition, we identified lessons from the preservation program that can be applied to portfolio reengineering, a program designed to address long-standing problems affecting FHA's insured portfolio of multifamily properties which is being tested on a limited scale. These lessons are discussed in appendix I.

To respond to the first two objectives, we obtained information on 40 properties that were processed by four of HUD's field offices. At each field office, the properties that we selected for review were those that were closest to the top of HUD's preservation "funding queue"—a list of properties with approved incentives that are awaiting funding. As of October 1996, 477 properties were on the funding queue. Twenty-seven of the 40 properties we reviewed represented sales to new owners, and 13 represented extensions of affordability restrictions by current owners. Because the properties we reviewed were not randomly selected, information about them cannot be projected to all of the properties on HUD's funding queue. Also, the property values that we used in addressing the first objective reflect the values of the properties that HUD and the property owners agreed to in establishing the properties' preservation funding. Essentially, these values reflect the "as is" fair market values of the properties based on their highest and best use as unsubsidized market-rate residential properties. As such, these values do not reflect any increases in property values that may result from improvements funded under the preservation program. We did not conduct our own independent assessments of property values.

Results in Brief

For the 40 properties that we reviewed, HUD approved $239 million for preservation grants or loans, which averages about $6 million per property. The approved funding ranged from about $580,000 to $27 million per property or from about $8,000 to $120,000 per unit. Overall, there were wide variations between the amounts of approved preservation funding and the values of the 40 properties we reviewed. The approved funding ranged from one-fourth of a property's value to more than 3 times its value. For 22 of the 40 properties, the approved funding exceeded the property's value by an average of 62 percent.

As part of the preservation funding for the 27 sales transactions we reviewed, HUD approved a total of $111.9 million for rehabilitation funding

that owners or purchasers had requested. This amount was 568 percent higher than the $16.7 million that HUD contractors had identified as needed to cover repairs that would return the properties to good condition. The approval of a higher funding level is largely attributable to HUD's broad criteria for funding rehabilitation costs presented in a 1994 HUD preservation policy notice. The policy on eligible rehabilitation costs is aimed at facilitating sales to nonprofit purchasers and maximizing the remaining life and quality of preservation properties. While HUD is likely to reduce rehabilitation funding for some of these properties in order to comply with fiscal year 1997 funding caps that the Congress established, the overall rehabilitation funding for the 27 properties will still be substantial.

HUD's administration of the preservation program is hampered by a number of factors that collectively limit the Department's ability to ensure that the program is being managed effectively and efficiently, that federal funds are being spent wisely, and that preservation operations are consistent with program requirements. These factors include the program's complexity, frequent changes in program requirements, the tight time frames under which approval and funding decisions are often made, program guidance that is fragmented and sometimes ambiguous or incomplete, and HUD's limited oversight of its field office operations. For example, we found these factors contributed to two cases in which HUD erroneously funded and in a third case planned to provide preservation funding that exceeded legislatively mandated funding caps by a total of $1.5 million. After we notified HUD of these situations, it took action to recover the excess funds. We also found two cases in which the Department used its waiver authority to provide preservation funds to properties whose operations were already governed by use agreements requiring the owners to maintain them as affordable housing for extended periods even if they prepaid their mortgages.

Background

The private owners of more than 3,600 multifamily housing projects (with about 397,000 units) developed during the 1960s and 1970s under sections 221(d)(3) and 236 of the National Housing Act have the option to prepay their federally subsidized 40-year mortgages after 20 years. In many cases, such prepayment could remove the restrictions that reserve these units for lower-income households. Concerned about the possible loss of these units from the affordable housing stock and the potential displacement of the residents, the Congress enacted the Emergency Low-Income Housing and Preservation Act of 1987 (also known as title II or ELIHPA) as a

temporary measure until a permanent program to preserve the units could be enacted. Title II authorized incentives to owners to continue low-income use restrictions through the life of the existing financing (generally 20 years or less) while effectively prohibiting prepayments unless HUD determined that there would be no adverse effect on the availability of affordable housing.

In 1990, title II was effectively replaced by the Low-Income Housing Preservation and Resident Homeownership Act (also known as title VI or LIHPRHA), which was aimed at ensuring that property units remained available and affordable to lower-income families and that the current owners were fairly compensated if they agreed to maintain affordability restrictions. Under title VI, limitations on the right to prepay were continued, but the amount of time that low-income use restrictions would be required was generally increased from the life of the existing mortgage to the remaining useful life of the property, or at least 50 years.

Under both preservation laws, owners may choose to receive incentives to continue low-income use restrictions at their properties without a change of property ownership (referred to as “extensions”) or they may sell their properties to new owners who agree to extend the low-income use restrictions (referred to as “sales” or “transfers”).

In fiscal year 1996, the Congress made further revisions to the preservation program. Most notably, it restored the right of owners to prepay their mortgages and to terminate affordability restrictions at their properties provided they agreed not to raise the rents for 60 days. During that year, HUD also revised the way it provided incentives. Specifically, most of the sales transactions funded in that year provided incentives to the buyer and the seller in the form of a grant. Subsequently, in the fiscal year 1997 appropriations law, the Congress required that all preservation transactions be provided in the form of grants or loans. For sales, the incentives go to the buyer and the seller in the form of a grant.[1] Grants may cover owner equity take-outs, rehabilitation (repairs, a repair contingency, and replacement reserves[2]), and transaction costs. For extensions, the owners receive the financial incentives in the form of a loan payable upon the sale of the property or the termination of the

[1]Prior to the use of grants and loans, HUD had provided incentives with increased levels of Section 8 project-based rental assistance and FHA-insured Section 241 (f) loans covering equity take-outs and repairs. These incentives were terminated by the fiscal year 1997 appropriations law to reduce excessive program costs.

[2]Replacement reserves are escrow funds established to ensure that funds are available for needed repair and replacement costs.

FHA-insured mortgage. Loans may cover equity take-outs and rehabilitation but not transaction costs. See appendix II.

The fiscal year 1997 appropriations law also modified the program. For example, new funding caps on the amount of incentives that may be provided for individual transactions were established. The 1997 law also reduced the overall federal funding from $624 million to $350 million, including $100 million specifically designated for residents of properties whose owners prepay the mortgages and end the low-income use restrictions.[3] The remaining $250 million may be used for preservation incentives. In 1996 and 1997, the Congress placed a funding priority on sales to priority purchasers—resident groups and several categories of nonprofit organizations that agree to extend affordability restrictions at the properties. However, in 1997, $75 million of the $350 million provided for the program was designated for three categories of properties, referred to as "carve-outs." The carve-out properties, discussed further in appendix III, include those where outside factors, such as earthquakes, delayed preservation funding requests. Carve-outs include both extensions and sales to priority purchasers.

The 1997 appropriations law established caps that limit the amount of funding that HUD can provide to preserve individual properties. Essentially, these caps limit grants to 7 times the annual fair market rent for the area in which the property is located and loans to the lesser of 6 times the annual fair market rent for that area or 65 percent of equity plus the funds to pay for needed repairs.[4]

The Preservation Funding Process

The funding process begins when an owner files a notice of intent to participate in the preservation program. HUD then has 9 months to provide the owner with, among other things, the results of an independent appraisal of the property. As part of the appraisal process, the Department also contracts for an assessment of the property's capital needs, which is used in the determination of preservation value. Within 6 months of receiving this information from HUD, the owner or purchaser is required to file a plan of action describing how they intend to continue the affordability restrictions. This plan must include, among other things, a

[3]Unused portions of the $100 million that are not needed for resident protection may be used to provide preservation funding.

[4]HUD establishes fair market rents annually for geographic areas and uses them as limits for the rents that HUD can subsidize under its tenant-based Section 8 certificate program. The caps used to establish funding limits for each preservation grant or loan take into account the mix of unit sizes in each project.

description of the federal incentives needed and an analysis of how any financial or physical deficiencies connected with the property will be addressed. The field office then reviews the plan of action and, for approved plans, submits summary funding information to HUD's preservation office at headquarters, which places the property on a funding queue. Subject to the availability of funds and the program's rules, the approved properties are funded in the order in which HUD placed them on the funding queue.

Status of the Preservation Program

According to HUD's data, through fiscal year 1996, 751 properties with more than 90,000 units have received preservation funding. In addition, as of October 1996, another 477 properties with about 56,000 units were on HUD's preservation funding queue. The HUD-approved funding for the 477 properties totaled approximately $1.6 billion. As of June 1997, HUD anticipated funding at least 69 of these properties in fiscal year 1997.

In 1996, the Congress restored the right of owners to prepay the mortgages on preservation properties and terminate use restrictions. According to HUD, as of March 5, 1997, the Department had received notices from the owners of 247 properties indicating their intent to prepay their mortgages, and the owners of 109 properties had done so. Appendix IV provides additional information on prepayments and legislative provisions to protect tenants from being displaced when property owners prepay.

Preservation Funding Often Exceeds HUD's Appraisal Values

For 22 of the 40 properties that we reviewed, the preservation funding approved by the Department exceeded the HUD-approved values of the properties. The approved funding is contingent upon the availability of appropriations and compliance with program rules, such as the funding caps mandated by the fiscal year 1997 appropriations law.

Preservation Funding Varies

HUD approved a total of $239 million to fund plans of action for the 40 properties that we reviewed, which averages $6 million per property or about $35,000 per unit.[5] The approved funding ranges from about $580,000 to $27 million per property or about $8,000 to $120,000 per unit. Overall, 41 percent of the funding covers equity take-outs, 52 percent covers rehabilitation needs (e.g., repairs, a repair contingency, and replacement

[5]This approved funding reflects the fiscal year 1997 funding caps. Without the caps, the approved funding would be $256 million. The percentages of funding by category are based on the unadjusted amount of $256 million because, as of May 1997, for a number of properties, it was not clear how the cuts would be allocated among the categories (i.e., equity, rehabilitation, and transaction costs).

reserves), and 7 percent of the incentives covers transactions costs.[6] The funding for the 40 properties reflects the caps mandated by the fiscal year 1997 appropriations law, except for 2 properties that had waiver requests pending as of May 15, 1997.

In comparison, according to HUD's data, the average amount of funding for the 58 properties that HUD had scheduled for fiscal year 1997 funding as of March 21, 1997, was approximately $4.3 million per property or about $26,000 per unit. However, because this amount does not reflect the effect of the 1997 funding caps for all properties, it is likely to be somewhat overstated. Twenty-four of the 40 properties we reviewed are included in these 58 properties.[7]

The amount of incentives approved for the 40 properties we reviewed varied considerably depending upon whether the transaction represented (1) a grant that reflected a sale to a priority purchaser or (2) a loan that reflected an extension where the current owner retains ownership. For instance, the amount of funding for the 27 sales we reviewed ranged from about $1 million to $27 million per property or an average of about $50,000 per unit. In contrast, the 13 loans ranged from about $580,000 to $9.8 million per property, averaging about $13,000 per unit. This variance in financial incentives is due to the significantly higher rehabilitation costs associated with sales. For example, the average per-unit rehabilitation cost for sales was over $31,000, while the cost to rehabilitate properties whose ownership was extended was about $2,600 per unit.

Preservation Funding Often Exceeded Property Values

We found the HUD-approved preservation funding exceeded property values for 22 of the 40 properties we reviewed. For these 22 properties, the funding approved was on average about 62 percent higher than the property values. The property values that we used in our analysis reflect the values of the properties that HUD agreed to in determining the amount of equity take-out to which the owners would be entitled.[8] The values are based on appraisals of the property conducted on behalf of HUD and the property owner. Essentially, these values reflect each property's "as is" fair market value based on its highest and best use as an unsubsidized

[6]See appendix V for a list of the incentives in the approved plans of action for each of the 40 properties we examined.

[7]In June 1997, HUD indicated it would fund an additional 11 properties with fiscal year 1997 funding, for a total of 69 properties. As of June 1997, 32 of the 40 properties we reviewed have either been funded or are scheduled for funding in fiscal year 1997.

[8]HUD refers to these values as preservation values. In this report, we refer to the preservation values as property values.

market-rate residential property. As such, the values do not reflect any increases in property values that may derive from improvements funded under the preservation program. We did not conduct our own independent assessments of property values.

The HUD-approved funding varied considerably compared to property values—ranging from about one-fourth of the value to more than 3 times the value of a property (see app. VI). As shown in table 1, the preservation funding for transactions involving sales under the title VI program totaled $200.7 million, compared with property values totaling $148 million. HUD officials said the primary reason that preservation funding exceeds property values is a 1994 policy decision that broadened the scope of rehabilitation work that may be funded under the program. This policy is discussed more fully in the next section of our report.

Table 1: Preservation Funding and Property Values for 40 Properties

Dollar in millions

Type of preservation funding	Number of projects	Total preservation funding[a]	Property value[b]	Difference (funding minus value)	Ratio of funding to value (percentage)
TitleVI					
Sales	27	$200.7	$148.0	$52.6	136
Extensions	3	8.0	18.8	(10.8)	43
Subtotal	**30**	**208.7**	**166.8**	**41.8**	**125**
Title II					
Extensions	**10**	**30.3**	**73.4**	**(43.1)**	**41**
Total	**40**	**$238.9**	**$240.2**	**$(1.3)**	**99**

Note: Totals may not add due to rounding.

[a]Preservation funding represents amounts in approved plans of action, adjusted for funding caps unless HUD had waiver requests pending (as of May 15, 1997).

[b]Property value represents the value of the property that HUD agreed to in determining the amount of equity to which the owner would be entitled—essentially, the “as is” fair market value based on the property’s highest and best use as an unsubsidized market-rate residential property, reflecting the deduction of all improvements as well as the repair and the conversion costs to transition the property from subsidized to market-rate housing.

Funding for Rehabilitation Has Grown Substantially

As a result of a 1994 policy decision by HUD, preservation funding for property rehabilitation has increased substantially, particularly for title VI sales transactions. This policy allows property owners and purchasers to receive preservation funding for a broad category of property

improvements, including improvements that "enhance the economic life of the project and its livability for the tenants."

HUD's Processes for Identifying and Funding Rehabilitation

HUD usually determines the rehabilitation needs of preservation properties and the funding to address these needs at two stages of the preservation process. Early in this process, HUD contracts for preservation capital needs assessments to determine the repairs that are needed at properties whose owners have applied to participate in HUD's preservation program. Later, owners or purchasers may request additional funding for repairs and improvements when they file plans of action under the program.

Preservation capital needs assessments are used to determine the "required" repairs, including corrections and replacements, needed to restore a property back to its original physical standards and their associated costs. As such, the costs reflect work needed to bring the property to "good" physical condition, which generally means that the property meets local codes and HUD's housing quality standards. In addition, the required repairs may include operational or energy upgrades that will increase the efficiency of how a property functions and/or its energy usage, such as new windows. Under most circumstances, required repairs may not include new amenities, facilities, and equipment for the property, nor replacement of items that are operational and functional, unless items are inconsistent—such as mismatched kitchen appliances. When HUD promulgated procedures and standards in 1992 for implementing title VI, the Department noted that the repairs identified in the initial capital needs assessments represent a beginning basis for estimating the rehabilitation needs and costs. However, the Department explained that the amounts would not be binding for purposes of funding rehabilitation under a plan of action because (1) the limited scope of some assessments may not have identified all of the costs associated with repairing the properties to meet HUD's housing quality standards and (2) the costs identified may be outdated by the time the plan of action is approved. Thus, these two exceptions seek to address shortcomings in some capital needs assessments and changed physical needs between the time of the assessment and the plan of action.

In 1994, HUD revised its policies on rehabilitation needs that may be funded under the preservation program to allow owners and purchasers to request funding for additional repairs as well as improvements that go far beyond those items covered in the capital needs assessments. Specifically, HUD determined that it would fund improvements that would enhance the

economic life of the property and/or its livability for the residents. Examples of the types of repairs HUD indicated it would fund include new amenities; replacing items that are near the end of their useful life; upgrading items that currently exist at the property, such as lighting to enhance security; modernization of unit space (e.g., common areas, kitchens, bathrooms, and new flooring) and energy upgrades not proposed as a required repair, such as utility conversions or energy-efficient windows. However, the policy specifically disallows certain items, such as swimming pools, saunas, bowling alleys, decks, dishwashers, and washers and dryers in individual units.

In its 1994 policy decision, the Department also indicated it would fund a 10-percent contingency for all repairs and improvements for sales of properties to priority purchasers under title VI. According to HUD preservation officials, this 10-percent contingency is now available for all preservation transactions being funded in 1997, including extensions to current profit-motivated owners. While unused repair contingencies are to be deposited in replacement reserve accounts for properties that are sold, any unused contingencies for extensions are to be used to reduce the balance of the capital loan provided under the preservation program.

Rehabilitation Funding Has Substantially Increased

For the 27 transactions involving sales to resident or nonprofit entities that we reviewed, purchasers requested and received approval for rehabilitation funding that greatly exceeded the needs that had been identified in HUD's preservation capital needs assessments (see table 2). Overall, the plans of action that HUD has approved for the sales transactions have provided funding for repairs (which include improvements) and repair contingencies that is 568 percent higher than the repairs identified in the preservation capital needs assessments.[9] That is, the Department initially identified about $16.7 million in needed repairs but agreed to provide about $111.9 million in funding (not including funding for replacement reserves). The average approved repair funding for the 27 properties was about $28,066 per unit. In comparison, according to HUD's data, the average approved repair funding for 37 sales

[9]These amounts do not fully reflect the impact of the fiscal year 1997 funding caps. As of May 1997, it was not clear how the funding cuts needed for a number of properties to comply with the funding caps would be allocated among equity, rehabilitation, and transaction costs. We note that if all of the approved funding in excess of the caps was taken from rehabilitation costs, these costs would still be 465 percent higher than the repairs identified in the capital needs assessments.

transactions scheduled for funding in fiscal year 1997 as of March 21, 1997, was about $11,168 per unit.[10]

The cost growth for preserving the 27 properties is largely attributable to funding improvements requested by nonprofit purchasers. Other factors that contribute to the growth, but to a far lesser extent, include (1) HUD's decision to include a 10-percent contingency for repairs and improvements in the plan-of-action funding and (2) inflation in the cases where the capital needs assessments are several years old.

Table 2: Repair Needs Identified in HUD's Capital Needs Assessments and Funding for Repairs in Plans of Action Approved by HUD for 40 Properties

Title/ transaction type	Number of projects	Repair needs identified in HUD's capital needs assessments	Per unit repair needs in HUD's capital needs assessments	Funding for repairs in plans of action approved by HUD[a]	Per unit plan of action repairs	Percent increase
Title VI Sales	27	$16,735,548	$4,199	$111,871,201	$28,066	568
Title VI Extensions	3	1,013,364	1,675	1,001,653	1,656	(1)
Subtotal-Title VI	**30**	**17,748,912**	**3,866**	**112,872,854**	**24,586**	**536**
Title II Extensions	**10**	**4,907,387**	**2,169**	**6,486,630**	**2,866**	**32**
TOTAL	**40**	**$22,656,299**	**$3,306**	**$119,359,484**	**$17,415**	**427**

[a]Includes funding for repairs and the repair contingencies and excludes funding for replacement reserve accounts. Reserves are included in the total rehabilitation funding for the 40 properties reported in appendix V.

In contrast, the funding increased by only 32 percent for the 10 transactions covering extensions funded or approved for funding with title II incentives through capital loans. The increases in rehabilitation costs for these properties generally stem from HUD's decision to fund a 10-percent repair contingency and, according to preservation guidance issued in January 1997, repairs that correct unsafe or life-threatening conditions that may have developed since the approval of the plan of action, and an inspection fee. Similarly, for the three extensions funded under title VI, only one owner requested a minor increase. According to a HUD official, because owners receive their incentives as a loan for extensions as

[10]As shown in appendix V, when funding for initial deposits to replacement reserves is included, the average approved amount of rehabilitation funding for the 27 properties was $31,230 per unit. In comparison, according to HUD's data, the average approved rehabilitation cost was $14,313 per unit for 37 sales scheduled for funding in fiscal year 1997 as of March 21, 1997. This average does not include the additional 11 properties (8 of which are included in our sample of 40 properties) that HUD approved for fiscal year 1997 funding in June 1997. Also, according to HUD's data, the average amount of approved rehabilitation funding for the 313 sales on HUD's November 1996 funding queue was $12,921 per unit (including initial deposits to replacement reserves).

opposed to a grant, they are motivated to minimize rehabilitation costs to the extent they want to minimize the debt they carry.

Cost Growth Stems From Broad Criteria and Goal to Transfer Properties to Nonprofits

The significant growth in funds for rehabilitation needs that we identified at the properties we reviewed is largely attributable to the broad criteria for funding capital needs, as contained in HUD's 1994 policy decision, and HUD's desire to facilitate sales of properties to nonprofit owners.

In 1994, HUD established broad criteria for rehabilitation work eligible for preservation funding. Allowable rehabilitation includes items that enhance living conditions, make a property more marketable, extend the life of material, enhance security, or reduce maintenance costs or other operating expenses. As a result, the scope of rehabilitation work eligible for preservation funding shifted from a narrowly prescribed standard focused on restoring properties to good condition to a broad standard, with few specific limitations, that generally supports rehabilitation proposals as long as they increase the life of the property or its livability for the residents.

According to HUD, this policy was established to encourage additional repairs to facilitate sales to nonprofit purchasers and to maximize the remaining life and quality of the affordable housing stock. HUD officials also cited other benefits of the policy, such as reducing properties' operating expenses, enhancing property values, and preventing the short-sighted, "band-aid" type solutions that have historically plagued the Department.

The rehabilitation funding requested in plans of action is based on assessments carried out for the owners or the purchasers and incorporates input from the tenants.[11] Each funding request is to be reviewed and approved by HUD field office architectural, engineering, and cost-processing staff on the basis of eligibility; benefit to the project, tenants, and HUD; cost-effectiveness; and availability of funds. For the 27 title VI sales we reviewed, we found that HUD often approved the rehabilitation funding requested by nonprofit buyers with little or no change, other than in some cases increasing funding for replacement reserves. For example, we reviewed 14 sales handled by HUD's Massachusetts and Connecticut state offices. In these cases, the amounts requested by the owners or buyers were essentially approved without any

[11]In contrast, the repair needs in preservation capital needs assessments are based on reviews carried out by contractors on HUD's behalf.

downward adjustment. In the only case in which HUD reduced the request for repairs (which includes improvements), it also increased the funding for replacement reserves, approving a total amount higher than the request. Furthermore, in five of these cases, the HUD field offices increased the funding incentives provided for replacement reserves with no downward adjustments for repairs. These 14 cases accounted for 58 percent of the funding approved for the 40 properties we examined.

For the three title VI sales we reviewed that were handled by HUD's Illinois state office, this office increased the repair funding requested in all cases by between about $300,000 and $394,000. In contrast, HUD's Los Angeles area office reduced the repair funding requested for seven properties by amounts ranging from about $30,000 to $1,274,000. It increased funding for repairs at the other three properties by amounts ranging from about $101,000 to $150,000.

In some cases we reviewed, it was questionable whether the reviews performed by HUD's field office staff were sufficient to ensure that the cost of items requested and approved for funding were prudent and represented the best use of preservation funds. For example, we found that the HUD-approved plan of action for Chauncy House Apartments in Boston, Massachusetts, included about $455,000 to replace the storm windows in all units within the first year, even though, according to a property official, the existing double-pane windows had been replaced between 3 and 4 years earlier. The plan of action indicated that the windows had to be replaced because of "structural inadequacies and moisture conditions between the prime windows and the interior storm windows," but it did not indicate the existing windows had been recently installed. While HUD officials believe that funding this item is appropriate, we question whether HUD's review was sufficient to determine whether there were less costly maintenance and repair tasks that could have been taken to correct moisture problems rather than replacing all of the windows again. Furthermore, the purchaser's plan of action for Chauncy House, which was approved by HUD without change, also includes about $536,000 for painting and caulking in its justification for replacement reserves. HUD's policies do not authorize the inclusion of painting and caulking for replacement reserve funding.[12] However, according to HUD preservation officials, while such items are not acceptable replacement

[12]The approved funding for Chauncy House is about $1.5 million in excess of the fiscal year 1997 funding cap. HUD's Massachusetts state office requested a waiver for this property on the basis that the funds were needed to renovate and repair the property and because the fair market rents for fiscal year 1997 "are not an accurate reflection of the market rents in Boston." On May 30, 1997, the Deputy Assistant Secretary for Multifamily Housing denied the waiver request.

reserve items, HUD state and area offices can waive this requirement because it does not represent a statutory or regulatory prohibition.

In addition, at one property we noted substantial differences in the estimates for replacing items in HUD's capital needs assessment compared with those in the plan of action. For Alewife Parkway Apartments in Cambridge, Massachusetts, a new refrigerator was estimated to cost $430 in the replacement reserve analysis included in HUD's April 1995 preservation capital needs assessment, while the purchaser's estimate in the June 1996 plan of action was $653. The preservation capital needs assessment per-unit estimate for oven/ranges was $330 compared with $547 in the plan of action, which also included an additional estimate of $429 for oven hoods. Similarly, the estimates for kitchen counters was $282 versus $435.

According to HUD field office staff, a key factor that has contributed to the increase in funding for rehabilitation is HUD's desire to facilitate sales to nonprofits. Several of these staff with responsibility for reviewing costs in the plan of action requests said that they interpreted headquarter's guidance on rehabilitation funding as directing them to give the tenants and nonprofits what they want. Furthermore, some of them view these requests for repairs as "wish lists," but they have approved the funding requests because of HUD's broad criteria and informal guidance. When we discussed our preliminary findings with the Department, HUD's General Deputy Assistant Secretary for Housing and other HUD officials acknowledged that the criteria for improvements were too broad given the limits of the staff's capacity to process cases and monitor the program. They also acknowledged the need to emphasize that the additional repairs are not intended to be a "wish list" in which nonprofits are given what they ask for without attention to the costs and benefits. Nonetheless, they believed that this weakness did not result in widespread excessive costs for improvements and repairs.

Equity Amounts Not Adjusted to Reflect Increased Capital Needs Funding

In HUD's preservation program, there is a direct link between a property's repair needs and the funding for equity an owner receives. Specifically, repairs required to restore the property to good condition (as well as upgrades and conversion costs associated with changing the property from subsidized housing to a market-rate property) reduce the equity HUD may provide to owners (see table 3).

Table 3: Hypothetical Example of Computation to Determine Owner's Equity Under HUD's Preservation Program

Property's appraised value	$12,000,000
Less required repairs (to restore property to good condition in compliance with local codes and HUD's housing quality standards as identified in preservation capital needs assessments)	(1,000,000)
Less upgrades and conversion costs (identified in appraisals)	(1,000,000)
"As is" preservation value	10,000,000
Less unpaid mortgage principal balance	(6,000,000)
Owner's equity	$4,000,000

HUD's 1994 policy on funding repairs and improvements acknowledged the link between repairs, improvements, and an owner's equity funding. That is, the policy noted that similar to the treatment of additional required repairs identified by HUD staff as a result of a time lapse between the preservation capital needs assessment and the plan of action, repairs approved at the plan-of-action stage that bring a property to a "good condition" would have the effect of decreasing the "as is" preservation value. Accordingly, an increase in required repair costs would decrease the amount of equity to which the owner would be entitled. In 1995, however, the Department determined that such downward adjustments of equity would be limited to instances where the owner had been fully aware of a required repair condition during the preservation capital needs assessment process and had not divulged it intentionally. This decision increases program costs to the extent additional repairs are funded but the equity payments to owners are not correspondingly reduced. Also, according to HUD's guidance, approved improvements are not considered in calculating the "as is" preservation value because the improvements would not be required to bring the property to a good condition or would not be encountered in the process of converting the property to an unsubsidized use. Thus, by definition, equity is not reduced for improvements the Department agrees to fund at the plan-of-action stage. According to program officials at headquarters, this policy stems from the Department's goal to encourage owners of these properties to sell them to resident groups and nonprofits and to maximize the remaining life and quality of its affordable housing stock.

At most of the 40 properties we reviewed, while HUD has approved significantly larger amounts of funding for rehabilitation than the amounts identified in HUD's capital needs assessments, we did not identify any

reductions in equity that had been made because of increased rehabilitation funding. In one case, we noted that HUD did reduce the owner's equity, but we were unable to determine from the information available whether this adjustment was made to reflect increased repair costs. Also, reductions in equity were made for a number of properties to meet the funding caps mandated by HUD's fiscal year 1997 appropriations act.[13]

Funding for Replacement Reserves May Be Excessive

Under HUD's preservation program, purchasers are eligible to receive funding for reserves to replace capital items, such as roofs and appliances, that will need to be replaced in future years. For the 27 properties we reviewed that involved sales, HUD approved about $12.6 million for deposits to replacement reserves, or about 10 percent of the rehabilitation needs the Department had approved. We believe that the amounts approved by HUD may be excessive for two reasons.

First, HUD allows the property owners to retain existing replacement reserve balances when selling properties under the preservation program and then provides funding to the purchasers to replenish those reserves. This policy can substantially add to the costs of the preservation program. For example, the owner of Alewife Parkway Apartments in Cambridge, Massachusetts, was allowed to retain the $539,659 replacement reserve balance when the preservation funding was provided in January 1997. HUD then included $900,000 in the capital grant given to the purchaser of the property to fund replacement reserves. However, if the existing replacement reserve balance had stayed with the property, HUD's replacement reserve funding would have been reduced to about $360,000.

A 1996 HUD preservation letter stated that for sales transactions the Department no longer requires that the existing account for replacement reserves remain with the property in most cases. The letter indicated that owners are entitled to keep the money in the reserve accounts because the appraisals did not reflect these amounts in establishing the values of the properties. HUD program staff told us that, upon request, HUD will allow owners who are selling properties under the program to retain the replacement reserve balances. However, the preservation staff also told us that there was considerable debate within HUD regarding the merits of this policy because replacement reserves were funded in large part from

[13]For some extension properties, equity reductions were also made for transaction costs and deposits to the replacement reserve accounts.

mortgage interest subsidies and project-based Section 8 rental assistance provided by the government.

When we discussed our preliminary findings with the Department, HUD's General Deputy Assistant Secretary for Housing and other HUD officials told us that it is the Department's position that it is never appropriate to allow owners receiving preservation funding to withdraw replacement reserve funds when an initial deposit is required to meet the property's future capital needs. They added that the Department's policy allowing such withdrawals is intended to reflect the intent of the Congress. To support this belief, the Department cited language from a 1992 House Banking Committee report that discusses the need for an amendment to the preservation law regarding replacement reserves. However, the proposed amendment—which would have included the amount of the reserve for replacement account in the preservation value of the property— was not enacted.[14]

Second, we found that HUD's process to determine the amount of replacement reserves funded at one property we reviewed—Alewife Parkway Apartments—did not ensure that all of the funding was actually needed.[15] Essentially, HUD determines the amount of initial deposits to replacement reserves that can be included in the preservation funding on the basis of the highest of three computations specified in the Department's preservation-processing instructions. HUD officials believed that this approach is appropriate because of the uncertainty in estimating replacement reserve needs and the sensitivity of the account as a resource in averting troubled-project situations.

For Alewife Parkway Apartments, the highest of the three required computations reflected the amount needed to replace items whose remaining useful life was expected to expire in the first 5 years after preservation funding as well as items whose replacement costs might be considered "weighty" in years 6 through 10. HUD determined that replacement reserve funding of about $1.2 million was needed. However, this calculation did not consider all of the appliances and other items that HUD was funding with the $5.5 million grant for property repairs. Instead,

[14]The House Banking Committee report accompanying the proposed amendment stated that the replacement reserves, which the report described as the rightful property of the owners, should be included in the appraised value of preservation projects, even though this may increase the cost of the program and the compensation to the owners.

[15]Our review of the documentation supporting preservation funding for replacement reserves and the reserve balance provided to owners was limited to Alewife Parkway Apartments, the one sales transaction in our sample that had received fiscal year 1997 funds as of February 1, 1997.

HUD's analysis was based on the earlier capital needs assessment that had assumed that the replacement of kitchen and bath appliances and other items would be funded over time from the replacement reserve account.

We also found that the documentation provided by the purchaser to support the initial request of $750,000 for the deposit to replacement reserves included several items, such as painting walls and ceilings and caulking, that are not acceptable replacement reserve items under HUD policies. As stated earlier, HUD officials said that state and area offices can waive the prohibition against including such items in replacement reserves. Furthermore, when the purchaser requested an additional $150,000 for replacement reserves, raising the total cost to $900,000, a mistake in its earlier analysis was cited, but information on the items that were erroneously excluded was not provided. Nonetheless, HUD approved the increase.

Administrative and Other Problems Limit Effective and Efficient Program Management

A variety of factors have hampered HUD's ability to administer the preservation program effectively and to ensure that federal funds are being spent wisely and in accordance with program requirements. We identified instances in which these factors contributed to errors and other problems in HUD's processing of preservation cases and also noted other questionable practices relating to HUD's awards of preservation funding. In addition, HUD continues to face difficulties in (1) targeting the program to only those properties whose owners will actually prepay and (2) ensuring that property owners that receive preservation funding comply with the affordability restrictions placed on the properties.

Program Administration Is Hampered by Various Factors

The preservation program has been described by some HUD officials, including HUD's General Deputy Assistant Secretary for Housing, as the Department's most complex multifamily housing program—a program that is very difficult for HUD to administer. On the basis of our review of the program's requirements, HUD's processing of individual preservation cases, and discussions with HUD preservation officials, we believe that program implementation is hampered by a variety of factors, including the following:

Frequent program changes and fragmented program guidance complicate identifying and complying with current policies and procedures. From its inception in 1987, the preservation program has been very complex, and it has been amended seven times. Preservation rules are contained in HUD's

numerous handbook transmittals, notices, and memoranda and—since April 1996—15 preservation letters that describe the changing program rules and provide numerous policy clarifications and changes. We found that it was difficult to get a clear understanding from program staff of HUD's current requirements in some cases, and that sometimes the program guidance was ambiguous or incomplete. One field office official characterized the program's criteria as "one big blur."

Staff responsible for processing the cases frequently change. Staff generally do not specialize only in preservation, and there is frequent turnover among staff familiar with the program because of other priorities and heavy workloads in the Department. Given the program's complexity and its fragmented guidance, these frequent staff changes increase the potential for error. In addition, some HUD staff who process preservation transactions expressed strong negative opinions about the program for various reasons. For example, some staff were troubled that it has provided substantial benefits to some owners who, as discussed in the next section, have not complied with HUD's policies; others questioned the substantial amount of funds being provided for rehabilitation needs.

Approval and funding decisions are often made under tight time frames. Frequently, new rules and requirements have had to be implemented in conjunction with program funding. Field staff were required to process their cases under the new rules to get them funded, often within tight time frames, thus limiting their review of funding requests. For example, transactions relating to the $75 million set-aside for "carve-out" properties in the fiscal year 1997 appropriations law had to be processed in about 5 weeks.

Data are aging and files are in poor condition. Many properties awaiting funding began the preservation process 3 or more years ago. Consequently, the data on which decisions are based have become more and more out of date. Furthermore, the files, upon which the funding amounts are based, can be voluminous and disorganized. We found that tracking case activity and final decisions was very difficult in some cases and that documentation supporting staff decisions was missing in others.

Program operations are decentralized and headquarters oversight is limited. Six preservation staff at headquarters provide the overall program guidance and rules and maintain a database of properties eligible for preservation funding and the transactions that have been funded. However, the headquarters preservation office does not conduct

systematic reviews of field offices that process preservation transactions. The information on the properties approved for funding that headquarters examines is generally limited to aggregate dollar amounts of the incentives approved by the field offices. Headquarters staff indicated that they obtain information about specific cases when they respond to questions from the field offices and that they also raise questions about some cases. However, the information that is routinely submitted to and reviewed by headquarters staff is insufficient, in our view, to allow them to identify many of the issues and problems that arise.

When we discussed our preliminary findings with the Department, HUD multifamily housing officials told us that they believed a number of the fundamental problems with the preservation program were the result of overly prescriptive legislative requirements, which they believed added administrative burden and complexity to the program and increased the potential for error. The officials also noted, however, that improvements could be made in program oversight. For example, they noted that if the program continues to be funded, ideally, preservation staff at headquarters should periodically visit all field offices to monitor transactions, provide technical assistance, and facilitate input from staff on programmatic issues. They also believed that the availability of sophisticated, real-time data management capability could greatly improve HUD's ability to manage the preservation program.

Administrative Problems Impair Oversight of Preservation Program Funding

The administrative weaknesses noted above have reduced HUD's ability to effectively oversee the use of preservation program funding. In our view, they have limited the Department's ability to ensure that the program is managed effectively and efficiently, that federal funds are being spent wisely, and that the program is carried out in a manner that is consistent with program requirements. For example, as we discussed above, HUD's oversight was not sufficient, in our view, to ensure that rehabilitation funding was provided in the most prudent and cost-effective manner.

We did not attempt to assess the extent to which each of the 40 transactions we examined was processed in accordance with preservation program requirements. However, in carrying out our work to address this report's objectives, we did note some errors and problems that appear to have resulted from the changing preservation program rules, tight processing time frames, and limited headquarters oversight of field offices, among other factors.

In particular, we found that HUD was not aware that it had approved incentives for three transactions that were $1.5 million over the program's fiscal year 1997 funding caps. For various reasons, errors totalling $1.5 million were made by field staff in determining whether the approved financial incentives exceeded the new fiscal year 1997 funding caps. At two properties processed by the Los Angeles office, Villa St. Andrews Apartments and Mountclef Apartments, the Department completed the transactions and provided excess amounts totalling $1.2 million to the owners. Specifically, HUD provided fiscal year 1997 funding for two of the carve-out properties that exceeded the 1997 caps by $731,283 and $499,123. These errors occurred because the field office staff used the incorrect number of apartment units in the funding limit formula for the Villa St. Andrews Apartments and did not calculate the funding limit for the Mountclef Apartments. These errors were not identified when the cases were reviewed by the field office or headquarters. After we brought the errors to HUD's attention, the Department recovered the excess funding from the new owners principally by reducing the funds that will be provided for rehabilitation work.[16] In the third case, the Connecticut state office was unaware that the approved incentives for the Tariffville Apartments were about $347,000 higher than the funding limits established in the 1997 appropriations law because the staff used an incorrect formula relating to a different preservation requirement to calculate the funding limit. According to HUD, the Connecticut state office requested a waiver from headquarters to fund the amount in excess of the cap, but it was denied.

We also found that HUD added projects to the preservation funding queue before the plans of action were received and approved. To allocate limited preservation funding, program staff told us that properties are placed on the preservation funding queue after field offices approve their plans of action. The properties then receive funding in the same order in which they are listed on the queue. We note that on July 12, 1996, HUD placed Bayview Towers, located in Stamford, Connecticut, on the preservation funding queue. However, the Bayview plan-of-action request for about $12.9 million (about $64,000 per unit) in preservation funding was not received in HUD's Connecticut state office until July 15, 1996, and was not approved until August 15, 1996. HUD made no adjustments to the funding requested in the plan of action. As a result of being placed on the queue in July before its plan of action was received and approved, this property is receiving fiscal year 1997 funding, whereas a number of properties that

[16]When a grant is provided under the preservation program, the equity take-out and replacement reserve funding is provided up-front, while the funding for rehabilitation (repairs and repair contingency) is provided after the rehabilitation work is completed.

were added to the funding queue later in July 1996 will not be funded this year. We also noted that Tariffville Apartments, also located in Connecticut, and six properties processed by HUD's Massachusetts state office were placed on the queue about a month before their plans of action were approved.

We also noted that, in one case we reviewed, HUD increased the preservation value of Alewife Parkway Apartments in Cambridge, Massachusetts, by about $5 million on the basis of its internal appraisal, resulting in a value that more closely coincided with the owner's appraisal. The preservation program generally requires that the preservation values are to be based on independent appraisals, with HUD having limited authority to make adjustments to the values. This approach provides some protection to the Department in terms of limiting the potential for fraud, waste, and abuse in establishing preservation values. However, in 1995, the Department's guidance indicated that negotiations could be used in cases where HUD's review appraiser believes that market data will support a value greater than 110 percent of the HUD appraisal in lieu of contracting for a third independent appraisal that would be binding. In this case, the Massachusetts state office indicated that there was not sufficient time to contract for a third independent appraisal. However, 9 months elapsed between the time that the owner raised questions about HUD's contract appraisal and the internal appraisal prepared by the Department. HUD officials acknowledged that, ideally, a third party appraiser would have been engaged in this case, but that because of timing issues and competing workload demands, they believed the field office's action was appropriate.

In discussing our tentative findings with the Department, HUD officials noted that it was inevitable that we would find some mistakes in the program given the number of transactions funded and the complex nature of the program. Nevertheless, they believed that, considering the numerous obstacles, HUD's administration of the program has been effective.

Some Uses of Program Funds Appear Questionable

In several instances HUD has provided funding to preserve properties that were already bound by affordability restrictions. The Department's preservation rules state that properties with use restrictions that would continue after prepayment, such as those which have received flexible subsidies,[17] are not eligible for preservation funding. Nonetheless, the

[17]Under the flexible subsidy program, loans were provided for capital needs in exchange for use agreements extending the affordability restrictions for the term of the original mortgage.

Department has granted waivers of this policy. During our review, we identified two such cases.[18] In one case, the Department provided $7.7 million in fiscal year 1996 preservation funding for Northwest Towers Apartments in Chicago, Illinois, which had a flexible subsidy contract requiring use restrictions until 2012. A primary argument made in the waiver request by the Deputy Assistant Secretary for Multifamily Housing was that it would be less expensive to preserve this property now rather than in 2012 because the appraisal value now—and the related equity payment—would be based on regulated rents that would be lower than the unregulated market rents that would apply in 2012. Given the limited resources available to the preservation program, we question whether providing preservation incentives to properties that will already be preserved as affordable housing for extended periods represents the best use of scarce federal resources. In addition, we noted that the appraisal value used to determine the equity payment to the owner was based on a rent structure from a property in another state rather than the property's existing rent structure. The rent structure used was derived from a use agreement for a property in St. Louis, Missouri, that had also received flexible subsidy funding and later had its mortgage prepaid. This rent structure was used after an appraisal using the property's actual rents showed that its preservation value was less than the outstanding balance on the property's mortgage, which prevented the property from moving forward in the preservation process. HUD determined that using the rent structure from the St. Louis property represented a "more reasonable basis for determining the rent levels and still maintaining a rent structure which would be considered affordable." HUD paid the owner about $2.5 million for equity.

HUD officials told us that the Department has approved preservation funding for three or four properties that had received flexible subsidies "on a trial basis" after the Congress had proposed language in an authorization bill that would have made one such property—Northwest Towers—eligible to receive preservation incentives. The officials stated that those approvals were given because HUD believed that allowing only a particular project to receive preservation incentives would inappropriately benefit one owner. However, they stated that HUD subsequently concluded that providing incentives to such properties was not an effective use of preservation funds and HUD has stopped granting such waivers.

[18]We did not review previously completed preservation transactions to determine how many involved flexible subsidies. However, in examining a completed case in one office, we found the Department had previously provided flexible subsidies to that property. This file also identified one other such case.

We also found that the Department has provided preservation funding to owners who HUD believed had violated its regulations. In 1994, HUD used preservation funding as a tool to negotiate a settlement agreement with an owner who, among other things, HUD believed had diverted funds from HUD-insured properties in violation of the regulatory agreements. HUD agreed not only to provide preservation funding for 8 of this owner's properties—the proceeds of which were to be used to repay the diverted funds and HUD-imposed fines—but for 26 other properties as well. Eight of the properties were funded in 1995, and funding for seven of the owner's other properties was provided with fiscal year 1997 funds under the carve-out category (see app. III). HUD officials told us that other than the funding provided to that owner under the carve-out category established in the 1997 appropriations act, the only preservation funding the Department had previously provided to that owner was an amount sufficient to cover the owner's obligations to repay the diverted funds and associated fines.[19] We found that HUD used preservation funding as a tool to reach settlement agreements covering two other properties in Connecticut in 1995 and 1996. Under the agreement, the owners were required to repay HUD about $4.5 million that had been diverted from the HUD-insured properties in violation of the regulatory agreements, along with a $500,000 fine.

Difficulties Exist in Targeting Program Funding and Monitoring Compliance

In addition to the administrative problems discussed earlier, HUD also faces two other issues in administering the preservation program: (1) how to target the program to properties whose owners will actually prepay and (2) how to ensure that property owners comply with affordability restrictions.

One of the problems that has existed under the preservation program throughout much of its history is how to target funds to only those properties whose owners would actually prepay their mortgages. The 1990 revisions to the preservation program addressed this problem by permitting HUD to limit incentive payments to property sales or extensions in rental markets that had an inadequate supply of decent and affordable housing. This provision, called the windfall profits test, was included in the law in response to the administration's concerns that the preservation program should not be used to provide incentives to owners who would not have prepaid because of local market conditions.

[19]As discussed further in appendix III, in 1994 HUD and the owner entered into an agreement to settle allegations in a HUD Office of Inspector General report that the owner had violated several regulatory agreements. The owner agreed to pay an $11.1 million settlement that included penalties. In 1995, HUD provided about $26.7 million in preservation funding, of which $22.2 million was for the owner's equity.

However, the windfall profits test was controversial and repealed by the Congress in 1992 before HUD implemented it because of concerns that a test designed to distinguish between properties with future value and eligible to receive incentives and those without value was imprecise, unfair, and unnecessary. The House Banking Committee considered the preservation program's appraisal system sufficient for determining if incentives should be made available to property owners and purchasers. The Committee expected that the appraisals and HUD's review of plans of action would protect against owners' receiving windfall profits.

Questions continue, however, concerning the extent to which the program provides incentives to owners of projects who are unlikely to prepay. HUD preservation staff in the field offices in which our work was performed had mixed views on the extent that owners would prepay if incentives were not available. Due to one area's bad economy, staff in that field office said it was unlikely that any of the owners who received incentives would have actually prepaid. Similarly, staff in another office told us that even though the Congress has restored the right of owners to prepay, they did not believe that most owners in their area were planning to prepay. On the other hand, staff in two other field offices felt very strongly that owners would prepay if the preservation program was discontinued. Due to the strong market in the area, one office is processing 40 prepayment applications. The other office is currently processing eight prepayment applications; and for the 10 projects that received incentives in fiscal year 1996, the preservation coordinator told us that most of those owners would have prepaid if incentives had not been offered to them.

Targeting preservation incentives to the owners that are most likely to prepay is difficult because there are no criteria that HUD can use to clearly identify such owners. According to HUD and industry officials, the appraisal process serves as a test for prepayment because a property's market value is a key factor in whether an owner will prepay. However, according to these officials, business considerations and the availability of financing also influence whether an owner actually decides to prepay.

According to some housing industry officials, however, one option that could potentially improve the targeting of preservation funding would be to have the states or the localities in which properties are located contribute a portion of the preservation funding—either from their own funding or from other housing-related federal funding that they receive. These officials stated that states or localities would only be willing to

provide funding to preserve properties that they believed were likely to prepay and truly needed to be preserved as affordable housing.

Concerns also exist about HUD's ability to monitor the properties that have received preservation funds to ensure that the long-term use agreements are adhered to by property owners. Without oversight, neither the Congress nor the Department can be assurred that the long-term affordability promised in exchange for financial incentives will be achieved. At the present time, HUD does not have a departmentwide system in place to identify and monitor owners' compliance with its various regulatory obligations, including the low-income affordability restrictions that owners agreed to extend in exchange for receiving preservation funds. The program's monitoring guidance in HUD's preservation handbook was prepared in 1993 and does not address the numerous, substantial changes that have occurred in the program since then.

Officials at three field offices expressed concerns over tracking all of the different use agreements for preservation properties, which vary in terms of the affordability restrictions depending upon when the properties were funded. In general, officials we contacted were most concerned about the lack of guidance on monitoring projects that no longer have mortgage insurance or existing Section 8 contracts. According to a HUD asset management chief, preservation projects can easily "fall off HUD's radar screen," particularly when the loan is paid off and Section 8 assistance is not renewed. This official said that due to limited resources, properties without mortgage insurance or Section 8 assistance were generally low priority in the field offices.

Conclusions

HUD's administration of the preservation program is hampered by a number of problems that, when taken together, seriously limit the Department's ability to ensure that the program is being managed effectively and efficiently, that federal funds are being spent wisely, and that the program is being carried out in accordance with program requirements.

We recognize that some of the problems affecting the program are due to its inherent complexity, the numerous programmatic changes that have taken place, and the compressed time frames under which decisions must be made. In our view, however, these problems are compounded by questionable HUD policies and internal control weaknesses. In particular, we believe that HUD's broad criteria for funding rehabilitation costs, its

policy of limiting downward adjustments in owners' equity when additional repair needs are identified to only those cases in which owners were previously aware of the needed repairs and intentionally did not divulge them, its limited oversight of field office activities, and its process for determining initial deposits to replacement reserves have not only increased preservation costs, but are also insufficient to ensure that federal funds are being used wisely, particularly in a budget-constrained environment. Also, HUD's lack of a uniform up-to-date system to monitor owners' compliance with preservation program requirements limits HUD's ability to ensure that owners are adhering to the long-term affordability restrictions placed on their properties.

Furthermore, we believe that HUD's use of waivers to provide funding to properties that would have already been required to continue to provide affordable housing, HUD's policy allowing owners to retain balances in replacement reserve accounts and then providing funding to purchasers to replenish those reserves, and HUD's use of the preservation program to resolve enforcement actions do not represent the best use of the program's limited funds.

Recommendations

To strengthen HUD's administration of the preservation program, we recommend that the Secretary of Housing and Urban Development undertake a systematic reassessment of the policies and internal controls governing the preservation program to ensure that they provide adequate assurance that the program's funds are being spent prudently and in accordance with legislative requirements. This assessment should focus, in particular, on policies and controls governing (1) the types of improvements eligible for rehabilitation funding and HUD's reviews of requests for such funding, (2) HUD's assessment of the effects of increases in rehabilitation funding on owners' equity, (3) HUD's determination of funds needed for initial deposits to replacement reserves, (4) HUD's oversight of field office activities, and (5) HUD's monitoring of the owners' compliance with affordability restrictions placed on their properties.

In addition, we recommend that the Secretary no longer fund preservation properties that are already bound by use agreements preserving the properties' affordability for extended periods or use preservation funds to resolve enforcement actions against the owners of multifamily properties and reconsider HUD's policy allowing owners to retain replacement reserve account balances when transferring properties to new owners.

Agency Comments and Our Evaluation

We provided a draft of this report to HUD for its review and comment. In commenting on the report, HUD did not disagree with the facts we presented in the report. However, while HUD accepted our view that internal controls and procedures for preservation program administration need to be strengthened, the Department believed that our conclusions unfairly characterized its overall administration of the preservation program. HUD stated that it believes its overall administration of the program has been effective and has resulted in the preservation of over 100,000 affordable housing units. HUD's comments do not change our view that this program is hampered by a number of factors—including frequent program changes, fragmented program guidance, frequent staff changes, and limited oversight—and that these factors collectively limit HUD's ability to ensure that the program is being managed effectively and efficiently, that federal funds are being spent wisely, and that the program is being carried out in accordance with program requirements.

In addition, HUD took exception to several aspects of our methodology and analysis: the sample of properties that we reviewed and our analyses of property values compared with preservation funding and replacement reserve funding. HUD asserts that our report is misleading because the properties in the sample were not randomly selected and thus overstates average program costs. The sample we used was not intended to estimate funding costs, but rather to respond to the report's objectives. As the Department acknowledges, our report clearly states that the 40 properties reviewed were not randomly selected and cannot be used to draw conclusions about all properties on HUD's funding queue. Instead, we focused our work on four field offices with substantial preservation workloads and properties at those offices that were likely to receive funding in fiscal year 1997 or 1998 (if the program is continued). The fact that our results cannot be statistically projected to the universe of preservation properties awaiting funding in no way invalidates our findings that the incentives provided for a substantial number of properties are high—in many cases far exceeding their preservation values—and that improvements are needed in HUD's controls over preservation funding. We also note that in fiscal year 1997, the Department has funded or plans to fund 32 of the 40 properties that we reviewed.

In addition, the Department states that preservation value is an inappropriate basis of comparison with program cost because it is not comparable to the value of a property after improvements funded by the preservation program have been made. We continue to believe that a property's preservation value was the best available measure that could

have been used to respond to the House Conference Report's request that we compare the funding provided to preservation properties to the properties' values. Our report recognizes that preservation values do not take into account any increases in property values that may result from improvements funded under the preservation program; however, as HUD officials have acknowledged, HUD does not require that an appraisal be performed to determine property value after improvements have been made. Furthermore, performing appraisals to determine a property's value after repairs and improvements are completed would have been difficult, if not impossible, at the properties we analyzed because they have either only recently received preservation funding or are still awaiting funding.

Regarding the analysis of replacement reserves, while the Department states that it has taken action to prevent overfunding of replacement reserves, it did not present any new information that alters the analysis in our report. We continue to believe that the Department's current methodology for determining the amount of reserves to fund and its oversight of the process for determining the reserves are insufficient to prevent overfunding.

The two recommendations in our report address eight specific issues. HUD did not take exception to the recommendations on five of the issues, but disagreed with three. Specifically, HUD indicated that its policy allowing owners selling their properties to keep the existing replacement reserve balances reflects congressional intent. However, we believe the information presented by HUD is insufficient to support this assertion. We continue to believe that HUD should reassess this policy that provides owners with replacement reserve balances that had been generally funded by federal subsidies and then replenishes these amounts with preservation funding provided to the new owners. In addition, the Department indicated that its existing procedures are adequate to avoid overfunding replacement reserves. As discussed above, we disagree and believe the Department should reassess the policies and internal controls governing replacement reserves.

Finally, the Department did not agree to reassess the effects of increases in rehabilitation funding on owner's equity. However, we believe that HUD misstates its current policy covering equity adjustments (reductions) for repairs that bring the property to marketable ("good") condition and thus does not address the issue raised in our report. Specifically, HUD's comments do not reflect the Department's current policy, promulgated in 1995, which limits the deduction for repairs being funded at the

plan-of-action stage that exceed the repairs identified in the capital needs assessments to only those instances where owners had intentionally concealed required repairs during the capital needs assessment process. As discussed in our report, this policy increases program costs to the extent that additional repairs are funded but the equity payments to owners are not correspondingly reduced. We continue to believe this policy should be reassessed. (The complete text of HUD's comments and our evaluation of them are provided in appendix VIII.)

We conducted our review from November 1996 through June 1997 in accordance with generally accepted government auditing standards. (See app. VII for a discussion of our scope and methodology.) We are sending copies of this report to appropriate congressional committees; the Secretary of HUD; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others on request.

Please contact me at (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix IX.

Judy A. England-Joseph
Director, Housing and
Community Development Issues

Contents

Letter	1
Appendix I Lessons From HUD's Preservation Program That Are Applicable to Its Portfolio Reengineering Program	34
Appendix II Preservation Funding Provided for Sales and Extensions	39
Appendix III Carve-Out Funding	42
Appendix IV Prepayment of Insured Mortgages on Preservation-Eligible Projects	44
Appendix V Preservation Funding by Category	48
Appendix VI Preservation Property Values and Funding	50

Appendix VII Objectives, Scope, and Methodology 52

Appendix VIII Comments From the Department of Housing and Urban Development and GAO's Evaluation 55

Appendix IX Major Contributors to This Report 67

Tables

Table 1: Preservation Funding and Property Values for 40 Properties 8
Table 2: Repair Needs Identified in HUD's Capital Needs Assessments and Funding for Repairs in Plans of Action Approved by HUD for 40 Properties 11
Table 3: Hypothetical Example of Computation to Determine Owner's Equity Under HUD's Preservation Program 15
Table II.1: Funding Provided to Owners and Purchasers Through Capital Grants for Sales to Priority Purchasers 39
Table II.2: Funding Provided Through Capital Loans for Extensions 41
Table V.1: Approved Preservation Funding for 40 Properties 48
Table VI.1: Values and Preservation Funding for 40 Properties 50

Abbreviations

ELIHPA	Emergency Low-Income Housing and Preservation Act
FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
LIHPRHA	Low-Income Housing Preservation and Resident Homeownership Act
PCNA	preservation capital needs assessment
POA	plan of action

Lessons From HUD's Preservation Program That Are Applicable to Its Portfolio Reengineering Program

While the purposes of the Department of Housing and Urban Development's (HUD) preservation and portfolio reengineering programs differ, a number of important similarities exist in terms of their data needs, administrative processes, and program structures. As such, a variety of learning experiences pertaining to the operations of the preservation program appear relevant to the effective development and management of HUD's portfolio reengineering program. These experiences include lessons relating to controlling program costs, screening owners, maximizing long-term housing affordability, ensuring sufficient time for evaluating and negotiating reengineering agreements, and avoiding frequent program changes.

HUD's Portfolio Reengineering Program

HUD initially proposed its portfolio reengineering program (then called "mark-to-market") in 1995 as a way to address the long-standing problems it faces in managing its insured Section 8 multifamily loan portfolio of about 8,600 properties. This portfolio of assets has been affected by three basic problems—high Section 8 subsidy costs, high exposure to defaults and losses to the Federal Housing Administration's (FHA) insurance fund, and the poor physical condition of some properties. HUD's portfolio reengineering proposal assumes that long-term cost savings can be achieved by adjusting a property's rents to market levels and writing down its mortgage as needed to allow operations to continue at a sustainable level. Initially, HUD also proposed to terminate FHA mortgage insurance on the properties and replace project-based Section 8 subsidies with portable tenant-based subsidies. HUD believed that these actions would help address the problems affecting the portfolio by subjecting properties to the forces and disciplines of the commercial market.

In April 1997, HUD and the Treasury Department jointly proposed the latest version of portfolio reengineering—a legislative package that, for the first time, would provide several forms of relief for owners with federal tax obligations resulting from reengineering. The proposed legislation's principal provisions would authorize HUD to adjust above-market Section 8 contract rents to local market conditions; restructure existing debt to projected cash flow levels while allowing owners to choose whether or not to retain FHA insurance on restructured debt; substitute tenant-based rental assistance, such as portable vouchers or certificates, for project-based Section 8 assistance in soft market areas unless the properties are targeted to elderly or disabled residents; and help ensure rehabilitation needs are met through the use of project reserves, restructured financing, or grants from HUD. The proposed tax changes would allow the amortization of tax

liabilities, resulting from debt forgiveness (in the case of mortgage write downs) and capital gains on sales to nonprofit organizations, over periods of up to 10 and 7 years respectively. With these tax changes, HUD hopes to remove a deterrent to owner participation in the portfolio reengineering effort and also make it easier for nonprofit organizations to purchase properties.

HUD is also administering two portfolio reengineering demonstration programs that were authorized in the appropriations acts for fiscal years 1996 and 1997. These programs were designed to test the portfolio reengineering concept.[1]

Controlling Program Costs

Both the preservation program and portfolio reengineering rely on the accumulation, analysis, and review of property-specific information, such as market values, operating income and expenses, and deferred maintenance and rehabilitation requirements. Inaccurate or unreliable information on HUD properties can lead to increased program costs, hinder HUD in its negotiating position with property owners, and delay specific program agreements. To reduce program risks and accurately assess the effects of portfolio reengineering on individual properties, housing experts we spoke with emphasized the need for HUD to include systematic and reliable approaches to determine property values, assess market income potential, and determine the levels and the costs of required physical improvements. In addition, they said that clear and reasonable rehabilitation standards and procedures for overseeing the development of rehabilitation assessments and cost estimates will also be important to holding down overall rehabilitation expenses and minimizing federal costs in the reengineering process. Moreover, to avoid the complications and problems experienced in the preservation program, it will be important that HUD has the capacity to administer and provide for the central oversight and controls needed to minimize exposure to waste, fraud, and abuse; adequate mechanisms to administer third-party technical service contracts for reengineering functions, such as negotiating agreements and executing due diligence work; and reliable information systems to track

[1]The 1996 program was available to owners whose Section 8 contract rent levels exceeded the fair market rents in the geographical area in which their properties were located. Through April 1997, two restructuring agreements were finalized with as many as 10 still under consideration. The 1997 program is limited to owners having expiring Section 8 contracts with aggregate rents exceeding 120 percent of the fair market rents in their local market areas. For Section 8 contracts lapsing in 1997, owners have the option of extending their contracts for 1 year at 120 percent of the fair market rents or volunteering for portfolio reengineering. By mid-April 1997, 34 owners out of approximately 370 having properties with 1997 Section 8 expirations had notified HUD that they desired to participate in the program.

the progress and the status of reengineering proposals and transactions. HUD multifamily officials noted that the complexity of administering about 700 preservation program transactions pales in comparison to the scope of negotiating 5,000 or more potential portfolio reengineering deals.

Screening Owners

Numerous HUD-subsidized properties have deteriorated financially and physically due to the mismanagement and neglect of owners. HUD's Secretary recently noted that serious problems continue to exist and, accordingly, has proposed several new initiatives and legislation to help the Department strengthen its efforts to identify problem owners; take enforcement actions, such as criminal or civil actions; and prevent the misuse of federal resources. Housing experts we interviewed agreed with the Secretary's assessment of its ownership problems and cited the need for HUD to screen out problem owners as part of its portfolio reengineering process.

Because of HUD's past ownership problems, housing experts believed that examining the background and management record of participating owners and taking appropriate steps to resolve specific ownership problems are important steps needed in the design of the portfolio reengineering process. Some housing experts also believed that the preservation program has provided effective models for transferring properties from existing owners to resident ownership and resident-endorsed nonprofit ownership. They believed that these models could successfully be adapted to portfolio reengineering.[2]

Maintaining Long-Term Housing Affordability

To ensure that subsidized multifamily properties are retained as affordable housing for low-income households, HUD uses legally binding agreements with owners that specify the length of time the properties must be affordable and preserved for low-income households. Determining the appropriate terms of long-term affordability use agreements is an issue in both the preservation and the portfolio reengineering programs. For example, while the title II preservation program established use restrictions for the remaining life of a property's financing, the length of the restrictions was substantially increased under title VI to the remaining useful life of a property.

[2]Recent work by HUD's Office of Inspector General has, however, led to some concerns about the extent to which the targeting of funding to sales transactions to priority purchasers (i.e., resident and nonprofit groups) increases the potential for the establishment of "sham" nonprofits. (Audit-Related Memorandum 97-BO-114-0801, Oct. 24, 1996).

Housing experts we spoke with believed that, for portfolio reengineering, careful consideration also needs to be given to designing use agreements that will help ensure the availability of affordable housing into the future. They emphasized the importance of balancing the benefits of portfolio reengineering with a continued commitment to preserving housing for low-income households. According to those we interviewed, a number of factors relevant to these determinations include establishing an acceptable length of time that housing properties are to remain under federal use restrictions, ensuring that properties remain available to tenant-based Section 8 residents, adequately providing rent and relocation protection for current residents, and ensuring that rents actually remain affordable to the range of households being targeted.

Ensuring Sufficient Time for Evaluating and Negotiating Reengineering Agreements

Interviews with housing experts, as well as our discussions with HUD staff during this review, indicated that HUD's field office staff were often under tight time frames and pressures to approve preservation applications. Similar concerns about compressed processing time frames were expressed about HUD's portfolio reengineering program. For example, during the fiscal year 1997 portfolio reengineering demonstration program, 180 days are allowed to perform the essential reengineering functions dealing with the application, due diligence, and negotiation processes. During this time frame, HUD and the owner must reach agreement on a wide variety of issues ranging from rent levels, operating expense budgets, and rehabilitation needs, to the most acceptable restructuring approach and financing needs. Each of these steps could encompass a number of time-consuming obstacles that HUD and its designated processors and/or contractors may be under pressure to address and find difficult to control. In general, housing experts believed that the 180-day time frame may not allow HUD the flexibility to adequately address the broad range of issues involved in the reengineering process. Accordingly, they believed that HUD's ability to administer the program within these time frames needs to be closely monitored and the time frames potentially reexamined.

Avoiding Frequent Program Changes

Other concerns that surfaced during our interviews, as well during our review at HUD field offices, were the frequent program changes and modifications to program operations and delivery mechanisms that were characteristic of the preservation program. Housing experts believed that deficiencies comparable to those that have plagued the preservation program can be minimized in reengineering if key areas of concern are resolved early and prior to implementation of a full-scale reengineering

effort. In general, they favored testing specific portfolio reengineering design concepts and methods of program administration. They believed that the demonstration effort, if properly administered, can be an advantageous tool in providing vital information and data on the range of questions and issues that will be assessed in reaching final agreement on the appropriate approach to resolve the multifamily portfolio problems.

Preservation Funding Provided for Sales and Extensions

Currently, preservation funding is provided through capital grants to owners and purchasers for sales to nonprofit owners who agree to extend affordability restrictions at the property. As shown in table II.1, these grants may cover owner equity take-outs, rehabilitation (i.e., repairs, a repair contingency, and replacement reserves), and transaction costs.[1]

Table II.1: Funding Provided to Owners and Purchasers Through Capital Grants for Sales to Priority Purchasers

Equity	**Recipient**: Owner selling property **Amount funded**: The preservation value minus outstanding mortgage debt. Essentially, the preservation value represents 100 percent of the "as is" fair market value of the property based on its highest and best use as an unsubsidized market-rate residential property, reflecting the deduction of all improvements, repair and conversion costs needed to transition the property from subsidized to market-rate housing.[a]
Repairs	**Recipient**: Purchaser **Amount funded**: Repairs to restore property to original condition and improvements that extend the life of the property or enhance the livability for residents.
Repair contingency	**Recipient**: Purchaser **Amount funded**: 10 percent of repair and improvement amount.
Replacement reserves	**Recipient:** Purchaser **Amount funded**: 100 percent of capital needs for 5 years and any shortfall for major capital needs in years 6-10 that will not be covered by required annual replacement reserve deposits.
Transaction costs	**Recipient**: Purchaser **Amount funded**: Costs include expenses incurred by purchasers associated with the acquisition, loan closing, and implementation of the plan of action. These costs may include such items as consultant fees, mortgagee retainer fees, training fees, and relocation allowances.

(Table notes on next page)

[1]Replacement reserves are escrow funds established to ensure that funds are available for needed repair and replacement costs.

Note: Priority purchasers are defined by HUD as resident councils, community-based nonprofit organizations with the support of a majority of the tenants, and any nonprofit organization or state or local agency that agrees to maintain low-income affordability. A priority purchaser may not be a related party to the owner.

[a]For sales, the value is based on the property's highest and best use, which may include something besides multifamily rental housing, such as a condominium. None of the 40 properties we examined has a highest and best use for something other than a residential market-rate rental property. In general, the preservation value agreed to represents either (1) the owner's appraisal value or 110 percent of HUD's appraisal if lower than the owner's, (2) an amount negotiated between HUD and the property owner based on an appraisal prepared by HUD, or (3) a value derived from a third, independent appraisal.

Owners who retain the properties and agree to extend the affordability restrictions receive fewer incentives than the incentives provided to owners and purchasers as part of preservation sales transactions (see table II.2). Rather than receiving a grant, extension owners receive a nonamortizing, noninterest-bearing loan that is due and payable when the mortgage is paid off, although the Department may defer payment of the loan under certain conditions. In addition, the loan does not cover 100 percent of the equity, as is available for sales. Instead, the maximum equity amount available is 65 percent of equity.[2] Also, with extensions, the owner must fund any amounts needed to meet HUD's reserve requirements. Finally, owner transaction costs are not funded for extensions, whereas with sales, new owners may receive funding to cover transaction costs.

[2]The maximum capital loan is the lower of 65 percent of the owner's equity plus the total approved costs for repairs or rehabilitation or six times the most recently published annual existing fair market rent using the appropriate apartment sizes and mix in the eligible project.

Table II.2: Funding Provided Through Capital Loans for Extensions

Equity	**Recipient**: Owner **Amount funded**: Up to 65 percent of the preservation value minus outstanding mortgage debt. Essentially, the preservation value represents the "as is" fair market value of the property based on its highest and best use as an unsubsidized market-rate residential property, reflecting the deduction of all improvements, repair and conversion costs needed to transition the property from subsidized to market-rate housing.
Repairs	**Recipient**: Owner **Amount funded**: Repairs to restore property to original condition and improvements that extend the life of the property or enhance the livability to residents.
Repair contingency	**Recipient**: Owner **Amount funded**: 10 percent of repair and improvement amount.

Note: With extensions, the current owner retains the proprerty and agrees to retain affordability restrictions.

In addition to the funding provided by the preservation program and the balances in replacement reserve accounts, owners selling their properties may also receive the balances in residual receipt accounts. Purchasers may be authorized to use excess rental income for specified purposes. Also, preservation properties would continue to receive project-based rental assistance from HUD for units covered by Section 8 rental assistance contracts. HUD estimates that, on average, about 40-45 percent of the units in preservation projects are covered by such contracts. Finally, most preservation properties would also continue to receive mortgage interest subsidies from HUD that reduce interest payments to as little as 1 percent.

Carve-Out Funding

The fiscal year 1997 Department of Veterans Affairs, HUD, and Independent Agencies appropriations act (P.L. 104-204) requires HUD to set aside $75 million of the $350 million in preservation program funding for three special categories of properties, commonly referred to by HUD and others as "carve-out" projects. Essentially, this provision gave properties falling within these categories priority over other properties that were awaiting preservation funding. The three carve-out categories are as follows:

- Properties that are subject to a repayment or settlement agreement that was executed between the owner and the Secretary of HUD before September 1, 1995.
- Properties whose submissions for funding were delayed because of their location in an area that was designated as a federal disaster area in a Presidential Disaster Declaration.
- Properties for which processing was suspended, deferred, or interrupted for a period of 12 months or more because of differing interpretations, by the Secretary of HUD and an owner or by the Secretary and a state or local rent regulatory agency, concerning the timing of filing eligibility or the effect of a presumptively applicable state or local rent control law or regulation on the determination of preservation value under section 213 of the Low Income Housing Preservation and Resident Homeownership Act (LIHPHRA) if the owner of such project filed a notice of intent to extend the low-income affordability restrictions of the housing or transfer it to a qualified purchaser who would extend such restrictions, on or before November 1, 1993.

While the legislation did not specify how the $75 million was to be allocated among the three categories, HUD decided to divide the $75 million equally among them. This resulted in 21 properties being funded as carve-outs, including 6 in Connecticut, 1 in Massachusetts, 9 in California, and 5 in New York.

The first carve-out category was used to provide preservation funding to seven properties in Connecticut and Massachusetts. These seven properties were owned by a person who had entered into an agreement with HUD in 1994 to settle allegations in a 1993 HUD Office of Inspector General report that the owner had violated several of the Department's regulatory agreements. More specifically, the Inspector General determined that the owner had violated HUD's regulatory agreements by diverting funds from the properties for personal and other business use. Specific violations included diverting $5.2 million, not forwarding $1.1 million of section 236 excess income to the Department, and not

timely forwarding $383,000 of Housing and Urban-Rural Recovery Act rent refunds to tenants. Additionally, the Inspector General found that the owner could not support $232,100 of accounting services and did not maintain the project's accounting systems entirely in accordance with HUD's requirements. The Inspector General's report also questioned the independence of a certified public accountant who performed project audits.

After the Inspector General identified these problems, the owner agreed with the Secretary of HUD to an $11.1 million settlement that included penalties. As part of the settlement agreement, the Department allowed the owner to apply for preservation funding on 34 of his projects and to use his equity to help defray the penalty costs.

In 1995, HUD provided about $26.7 million in preservation funding for eight of this owner's projects, of which $22.2 million was for owner equity. The $25 million the owner received in April 1997 included about $18 million for equity. Thus, while the owner's violations and penalties amounted to $11.1 million, the owner received a total of about about $51.7 million in preservation funding.[1] All of the properties were funded as extensions under Title II of the preservation program, thus allowing the owner to continue ownership of the properties.[2]

Under the second carve-out category, HUD provided about $25 million in funding to nine California properties whose applications were processed by HUD's Los Angeles field office. HUD determined that the submissions on these properties had been delayed by the 1994 earthquake in California.

Under the third carve-out category, HUD provided about $25 million in funding to five properties. Each of these properties' applications was handled by HUD's New York field office.

[1]Reflecting program changes discussed in the report, the funding was provided with FHA-insured Section 241(f) loans in 1995 and with nonamortizing, noninterest-bearing loans in 1997 that are due and payable when the mortgages are paid off (although the Department may defer payment of the loan under certain conditions).

[2]In addition to the properties already funded, the owner has nine more properties awaiting preservation funding. We also noted that at one of the other properties we examined, Mishawum Park Apartments in Charlestown, Massachusetts, the owner had entered into an agreement with HUD to settle alleged violations identified by HUD's Inspector General. The Inspector General determined that the owner had diverted funds and charged higher than normal legal fees for work at the property. The preservation plan of action HUD has approved would provide about $29.7 million to that property.

Prepayment of Insured Mortgages on Preservation-Eligible Projects

In the fiscal year 1996 HUD appropriations act (P.L. 104-134), the Congress restored the right of owners to prepay their mortgages and to terminate affordability restrictions at their properties provided the owners agreed not to raise the rents for 60 days. This legislation also provided certain protections for tenants living in properties whose owners decide to prepay. The fiscal year 1997 HUD appropriations act (P.L. 104-204) also authorized protections for tenants living in properties whose owners prepay, although the specific protections available to certain classes of tenants were modified. While owners are no longer required to request HUD approval prior to prepayment, HUD has emphasized that they must notify the Department if they intend to prepay so that steps may be taken to provide affected tenants with the statutory protections.

This appendix provides information about the prepayments that have occurred since the 1996 legislation, the protections available to affected tenants, and outstanding issues related to the potential impacts of prepayments on the tenants. Because prepayment rights were restored relatively recently, it is too soon to tell what the effects on tenants will actually be.

Extent of Prepayments

According to data from HUD's preservation office, as of March 5, 1997, owners had filed notices of intent to prepay the mortgages on 247 projects with about 23,000 units; of these, 131 notices were filed for prepayment in fiscal year 1996 and 116 were filed for prepayment in fiscal year 1997.

These notices covered projects located in 37 states.[1] About 23 percent, or 58 notices, were filed for projects located in California. However, the majority of states have had no more than 5 notices of intent filed, and only four (Oregon, New Mexico, Washington, and California) have had more than 15 notices.

Of the 247 notices filed at the time of our review, owners had actually prepaid the mortgages on 109 of the projects with about 9,800 units. There were at least one prepayment in each of 35 states and no more than five prepayments in most states. There were 12 and 10 prepayments in California and Maryland, respectively. In March, HUD's preservation office initiated a survey of owners to estimate the volume of prepayments likely to occur in the remainder of fiscal year 1997.

[1]Data on the extent of prepayments by state include Washington, D. C.

Tenant Protections

Several pieces of legislation have set forth provisions to help protect tenants from being displaced when property owners prepay. Although the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA) of 1990 (P.L. 101-625) placed substantial restrictions on owners' ability to prepay the mortgages on their properties, the legislation also included protections for tenants in case an owner did prepay. Depending on the type of tenant, LIHPRHA generally allows eligible tenants to receive tenant-based Section 8 assistance or to remain in their current unit for 3 years with no rent increases (except for increases necessary for increased operating costs). These protections are generally available to tenants who are not already receiving project-based or tenant-based Section 8 assistance at the time of prepayment. According to HUD guidance, tenants who are already receiving assistance at the time of prepayment continue to receive the assistance under its existing terms. The amount that they contribute to rent is not affected, and the assistance remains in place until it expires or is terminated under regular program rules.

The fiscal year 1996 HUD appropriations legislation restored the right of owners to prepay the mortgages on preservation-eligible housing, so long as they agreed not to raise the rents for 60 days after prepayment.[2] The law also further defined some of the tenant protections authorized by LIHPRHA. For example, it more specifically identified those eligible for tenant-based Section 8 assistance as unassisted low-income tenants residing in the housing on the date of prepayment whose rent, as a result of an increase occurring no later than 1 year after the date of prepayment, exceeds 30 percent of adjusted income.[3] The law also added that these tenants may not pay less for rent than they were paying at the time of mortgage prepayment. Under the statute, any tenant receiving this tenant-based assistance may elect to (1) remain in the housing unit and if the new rent exceeds the normal Section 8 limit, the new rent will be considered the applicable limit,[4] or (2) move from the housing and the rent will be subject to the normal Section 8 limits. Because this special Section 8 assistance will subsidize rents higher than the normal Section 8 limits so that tenants

[2]For the purposes of the preservation program, the terms prepayment and termination of mortgage insurance are used interchangeably. Whenever either of the terms is used, it should be taken to mean both.

[3]HUD guidance clarifies that the term low-income tenants includes very low-income tenants.

[4]The new rent will be considered the applicable standard if the administering public housing authority deems it reasonable. If the rent for the unit is not reasonable, as determined by the public housing authority, the family may either move and receive the Section 8 tenant-based assistance or elect to stay in the unit, receive the tenant-based assistance, and pay the difference between the rental amount that the public housing authority deems appropriate and the actual gross rent for the unit.

can remain in their current units if they wish, it is referred to as "sticky" Section 8 assistance.

The fiscal year 1997 HUD appropriations legislation continued the right of owners to prepay, with the 60-day restriction on rent increases, but somewhat modified the protections available to tenants affected by a prepayment. Specifically, the law expanded the category of tenants eligible to receive the "sticky" Section 8 assistance to include moderate-income tenants who are elderly, disabled, or residing in a low-vacancy area. Before the 1997 legislation, these classes of tenants were eligible for the 3-year continued occupancy protection of LIHPRHA. However, under the 1997 statute, the "sticky" tenant-based Section 8 assistance is given in lieu of the protections (relocation assistance, 3-year continued occupancy, and required acceptance of Section 8 tenants) provided under LIHPRHA. According to HUD guidance, during fiscal year 1997, as long as sufficient appropriations are available to provide tenant-based assistance, the LIHPRHA protections are not applicable. For projects that had filed notices of intent to prepay as of March 5, 1997, HUD estimates that the 1-year cost of "sticky" tenant-based Section 8 assistance provided under the fiscal year 1996 and fiscal year 1997 statutes will be about $24 million. For projects that had actually prepaid as of the March date, the 1-year cost of tenant-based assistance is expected to be about $14 million.

HUD issued several memorandums in 1996 and 1997, referred to as Preservation Letters, that provide guidance on implementing the provisions of the preservation program, including the protections for tenants affected by mortgage prepayment. For instance, according to the Preservation Letters, owners who prepay must provide HUD with timely information necessary to ensure that those tenants who could be displaced by a prepayment receive the appropriate assistance.[5] In addition, the guidance for fiscal year 1996 prepayments clarifies that the 3-year occupancy protection of LIHPRHA is also available to unassisted low- and very low-income tenants whose rents are not raised during the first year following prepayment and who live in a low-vacancy area or are special needs tenants.

Potential Impacts of Prepayments on Tenants

It is not yet clear how restoring prepayment rights will affect tenants. While HUD does collect information from owners of properties that prepay in order to determine the amount of Section 8 assistance that tenants will

[5]The owner of a project that currently has Section 8 assistance in 100 percent of its units is exempted from the reporting requirements.

require, it has not established a system to track what happens to tenants following prepayment. For purposes of estimating the amount of Section 8 assistance required, the preservation office assumes that all tenants who receive "sticky" Section 8 assistance will choose to remain in the project, but they do not collect data on the extent to which this assumption is actually true, nor the extent to which tenants choosing to relocate have been able to find suitable, affordable housing with their tenant-based Section 8 assistance.

One issue that could have a substantial effect on the extent to which prepayment leads to tenant displacement is how long the more costly "sticky" Section 8 assistance that tenants receive will be renewed at its enhanced level. If the assistance reverts to normal Section 8 assistance rules, tenants in projects with rents above the normal limit would face a choice of relocating and obtaining housing within the regular Section 8 limits or remaining in their current residences and paying the difference between the project rent and the normal Section 8 limit. Moderate-income tenants who might not qualify for Section 8 assistance under the regular Section 8 rules could be required to pay their unit's full rent amount or relocate to housing that they can afford without rental assistance. HUD officials told us that HUD's fiscal year 1998 budget request proposes the renewal of "sticky" Section 8 assistance at its enhanced level.

Another issue related to the impact of prepayments on tenants is the possibility that owners might prepay the mortgages on their projects but wait to raise rents until more than 1 year after prepayment. As discussed above, tenants are only eligible for "sticky" Section 8 assistance if their rent increases within 1 year after prepayment, causing their rent payment to exceed 30 percent of adjusted income. Under fiscal year 1996 rules, low- and very low-income unassisted tenants whose rent does not increase within 1 year after prepayment could still receive the 3-year continued occupancy protection of LIHPRHA if they live in a low-vacancy area or are special needs tenants.[6] However, under the fiscal year 1997 appropriations act, unassisted low- and very low-income tenants whose rent does not increase until after the first year could be displaced because the 3-year continued occupancy protection is not available and they were ineligible for "sticky" Section 8 assistance at the time of prepayment.

[6]HUD guidance for the fiscal year 1996 rules defines special needs tenants as those who are elderly or disabled and large families of five or more persons requiring units with three or more bedrooms.

Preservation Funding by Category

This appendix provides a table that lists the approved preservation funding by category (equity, rehabilitation, and transaction costs) for the 40 properties that we reviewed. The rehabilitation category includes funding for repairs (including improvements), a repair contingency, and replacement reserves. The approved funding in this table does not reflect the fiscal year 1997 funding caps because, as of May 1997, it was not clear how the cuts for a number of properties would be allocated among these categories.

Table V.1: Approved Preservation Funding for 40 Properties

			Category			
Property name	**Total units**	**Owner's equity**	**Rehabilitation**	**Transaction costs**	**Actual or estimated funding**	**Per unit funding cost**
Title VI—Sales						
Bayview Towers	200	$7,743,847	$3,774,017	$1,335,571	$12,853,435	$64,267
Jerome Estates	176	3,214,000	1,901,008	334,372	5,449,380	30,962
Tariffville Apartments	81	1,890,639	2,427,001	276,168	4,593,808	56,714
808 Memorial Drive	301	6,722,297	7,684,287	1,262,808	15,669,392	52,058
Alewife Parkway Apartments	274	7,126,312	6,929,151	818,368	14,873,831	54,284
ETC & Associates	71	1,394,769	1,665,916	469,950	3,530,635	49,727
Commonwealth Apartments	118	1,684,670	6,329,760	935,925	8,950,355	75,850
Glenville Apartments	117	1,426,698	6,858,878	953,510	9,239,086	78,967
Warren Avenue Apartments	30	1,178,757	1,775,642	652,313	3,606,712	120,224
Chauncy House	87	1,948,949	3,581,861	768,274	6,299,084	72,403
Milliken Apartments	201	2,410,771	2,044,195	67,912	4,522,878	22,502
Spring Meadow Apartments	270	718,859	16,013,411	1,573,781	18,306,051	67,800
Greenfield Gardens	201	2,641,596	6,511,954	792,371	9,945,921	49,482
Mishawum Park Apartments	337	6,403,590	19,573,319	3,782,924	29,759,833	88,308
Waukegan Terrace	140	1,631,538	3,072,120	593,398	5,297,056	37,836
Cambridge Manor	312	3,762,047	4,993,822	338,306	9,094,175	29,148
Kenmore Plaza	324	7,428,629	5,572,626	426,408	13,427,663	41,443
Villa St. Andrews	14	372,171	1,124,440	148,760	1,645,371	117,527
39th Street Manor	46	897,009	516,650	105,662	1,519,321	33,029
Mountclef Apartments	18	761,485	916,206	120,240	1,797,931	99,885
Haven 501	50	578,124	387,825	176,295	1,142,244	22,845
Haven 502	105	858,948	867,905	218,755	1,945,608	18,530
Casa Development	158	836,102	8,053,315	177,829	9,067,246	57,388
Manhattan Manor	26	612,452	506,140	183,090	1,301,682	50,065
Holiday 101-B	117	1,783,600	5,617,180	969,200	8,369,980	71,538

(continued)

Property name	Total units	Owner's equity	Category: Rehabilitation	Category: Transaction costs	Category: Actual or estimated funding	Per unit funding cost
Los Arboles	43	2,101,866	4,089,560	676,540	6,867,966	159,720
Granada Gardens	169	6,924,451	1,695,100	331,510	8,951,061	52,965
Total title VI sales	**3,986**	**$75,054,176**	**$124,483,289**	**$18,490,240**	**$218,027,705**	
Average title VI sales per unit		**$18,829**	**$31,230**	**$4,639**		**$54,698**
Title VI—Extensions						
La Brea Gardens Apartments	185	$1,487,013	$444,658	0	$1,931,671	$10,441
Hollywood Knickerbocker	282	2,607,540	323,355	0	2,930,895	10,393
Green Hotel Apartments	138	2,902,258	233,640	0	3,135,898	22,724
Total title VI extensions	**605**	**$6,996,811**	**$1,001,653**	**0**	**$7,998,464**	
Average title VI extensions per unit		**$11,565**	**$1,656**	**0**		**$13,221**
Total Title VI	**4,591**	**$82,050,987**	**$125,484,942**	**$18,490,240**	**$226,026,169**	
Average title VI per unit		**$17,872**	**$27,333**	**$4,027**		**$49,232**
Title II—Extensions						
Sunset Apartments	231	$3,056,171	$173,197	0	$3,229,368	$13,980
Brookside Gardens	32	653,624	66,908	0	720,532	22,517
Kennedy Building	115	2,150,730	177,933	0	2,328,663	20,249
Crestwood Park II Apartments	150	2,878,710	272,998	0	3,151,708	21,011
Summerhill Apartments	104	1,891,061	265,438	0	2,156,499	20,736
Woodbury Apartments	188	3,541,218	85,673	0	3,626,891	19,292
Willowcrest Apartments	151	3,273,247	339,853	0	3,613,100	23,928
Saybrook Apartments	30	524,688	57,712	0	582,400	19,413
Stoneycrest Apartments	49	952,116	110,721	0	1,062,837	21,691
Lincoln Village	1213	4,850,141	4,936,198	0	9,786,339	8,068
Total title II extensions	**2,263**	**$23,771,706**	**$6,486,631**	**0**	**$30,258,337**	
Average title II extensions per unit		**$10,505**	**$2,866**	**0**		**$13,371**
Grand total	**6,854**	**$105,822,693**	**$131,971,573**	**$18,490,240**	**$256,284,506**	
Average per unit		**$15,440**	**$19,255**	**$2,698**		**$37,392**

Note: rehabilitation includes repairs and improvements, repair contingency, and replacement reserves.

Preservation Property Values and Funding

This appendix provides a table that lists the property values and preservation funding for the 40 properties that we reviewed. Property value represents the value of the property that HUD agreed to in determining the amount of equity to which the property's owner would be entitled—essentially, the "as is" fair market value based on highest and best use as unsubsidized market-rate residential properties, reflecting the deduction of all improvements as well as the repair and the conversion costs to transition the property from subsidized to market-rate housing. Preservation funding represents the amounts in approved plans of action, adjusted for the caps mandated by the fiscal year 1997 appropriations law, except for the two cases where HUD had waiver requests pending as of May 15, 1997.[1]

Table VI.1: Values and Preservation Funding for 40 Properties

Property name	Total units	Property value	Actual or estimated funding	Difference (funding minus value)	Ratio of funding to value (percentage)	Per unit funding costs
Title VI—Sales						
Bayview Towers	200	$12,380,000	$12,853,435	$473,435	104	$64,267
Jerome Estates	176	5,595,813	5,449,380	–146,433	97	30,962
Tariffville Apartments	81	2,951,548	4,246,956	1,295,408	144	52,432
808 Memorial Drive	301	23,500,000	14,613,984	–8,886,016	62	48,551
Alewife Parkway Apartments	274	12,300,000	14,873,831	2,573,831	121	54,284
ETC & Associates	71	2,324,000	3,530,635	1,206,635	152	49,727
Commonwealth Apartments	118	3,784,000	8,023,344	4,239,344	212	67,994
Glenville Apartments	117	2,904,000	7,257,936	4,353,936	250	62,034
Warren Avenue Apartments	30	1,540,000	3,606,712	2,066,712	234	120,224
Chauncy House	87	3,550,000	6,299,084	2,749,084	177	72,403
Milliken Apartments	201	5,300,000	4,522,878	–777,122	85	22,502
Spring Meadow Apartments	270	4,840,000	15,812,496	10,972,496	327	58,565
Greenfield Gardens	201	5,820,119	9,945,921	4,125,802	171	49,482
Mishawum Park Apartments	337	13,821,500	27,488,748	13,667,248	199	81,569
Waukegan Terrace	140	3,140,000	5,297,056	2,157,056	169	37,836
Cambridge Manor	312	7,457,800	9,094,175	1,636,375	122	29,148
Kenmore Plaza	324	12,248,500	13,427,663	1,179,163	110	41,443
Villa St. Andrews	14	582,835	914,088	331,253	157	65,292
39th Street Manor	46	1,403,495	1,519,321	115,826	108	33,029
Mountclef Apartments	18	1,150,000	1,298,808	148,808	113	72,156

(continued)

[1]HUD disapproved the waiver requests on May 30, 1997.

Property name	Total units	Property value	Actual or estimated funding	Difference (funding minus value)	Ratio of funding to value (percentage)	Per unit funding costs
Haven 501	50	1,039,500	1,142,244	102,744	110	22,845
Haven 502	105	2,027,725	1,945,608	–82,117	96	18,530
Casa Development	158	2,359,191	8,090,544	5,731,353	343	51,206
Manhattan Manor	26	932,800	1,301,682	368,882	140	50,065
Holiday 101-B	117	2,812,000	5,965,932	3,153,932	212	50,991
Los Arboles	43	2,897,335	3,181,248	283,913	110	73,983
Granada Gardens	169	9,364,000	8,951,061	–412,939	96	52,965
Total title VI sales	**3,986**	**$148,026,161**	**$200,654,770**	**$52,628,609**	**136**	
Average title VI sales per unit		**$37,137**		**$13,203**		**$50,340**
Title VI—Extensions						
La Brea Gardens Apartments	185	$4,512,000	$1,931,671	–2,580,329	43	$10,441
Hollywood Knickerbocker	282	7,864,800	2,930,895	–4,933,905	37	10,393
Green Hotel Apartments	138	6,406,834	3,135,898	–3,270,936	49	22,724
Total title VI extensions	**605**	**$18,783,634**	**$7,998,464**	**–$10,785,170**	**43**	
Average title VI extensions per unit		**$31,047**		**–$17,827**		**$13,221**
Total title VI	**4,591**	**$166,809,795**	**$208,653,234**	**$41,843,439**	**125**	
Average title VI per unit		**$36,334**		**$9,114**		**$45,448**
Title II—Extensions						
Sunset Apartments	231	$7,567,447	$3,229,368	–$4,338,079	43	$13,980
Brookside Gardens	32	1,107,538	720,532	–387,006	65	22,517
Kennedy Building	115	3,509,726	2,328,663	–1,181,063	66	20,249
Crestwood Park II Apartments	150	5,016,199	3,151,708	–1,864,491	63	21,011
Summerhill Apartments	104	3,582,473	2,156,499	–1,425,974	60	20,736
Woodbury Apartments	188	7,035,941	3,626,891	–3,409,050	52	19,292
Willowcrest Apartments	151	5,745,127	3,613,100	–2,132,027	63	23,928
Saybrook Apartments	30	1,041,604	582,400	–459,204	56	19,413
Stoneycrest Apartments	49	1,840,327	1,062,837	–777,490	58	21,691
Lincoln Village	1,213	36,937,804	9,786,339	–27,151,465	26	8,068
Total title II extensions	**2,263**	**$73,384,186**	**$30,258,337**	**–$43,125,849**	**41**	
Average title II extensions per unit		**$32,428**		**–$19,057**		**$13,371**
Grand total	**6,854**	**$240,193,981**	**$238,911,571**	**–$1,282,410**		
Average per unit		**$35,044**		**–$187**		**$34,857**

Objectives, Scope, and Methodology

The House Conference Report 104-812 accompanying the fiscal year 1997 appropriations act (P.L. 104-204) included a request for a GAO study on the preservation program to assist the Congress in making a determination of whether the program is the most cost-effective way to provide affordable housing opportunities to low-income families. As requested, we reviewed (1) the funding provided to preservation properties as compared with their values, (2) the levels of rehabilitation grants provided to properties compared with their physical needs, and (3) the administrative and other problems that have arisen under the program. In addition, we identified lessons from the preservation program that can be applied to portfolio reengineering, a program currently being tested on a limited scale designed to address long-standing problems affecting FHA's insured portfolio of multifamily properties.

To respond to the first two objectives, we obtained and reviewed information on 40 properties at four HUD field offices located in Boston, Massachusetts; Chicago, Illinois; Hartford, Connecticut; and Los Angeles, California. Each of these offices had a substantial preservation workload in terms of the cases and/or dollars for which it was responsible. The properties we selected for review at each field office were those that were the highest on HUD's November 1996 "funding queue" —the list of properties with approved incentives that were awaiting funding as of that time. As of June 1997, 32 of the 40 cases we reviewed have either been funded or are scheduled for funding in fiscal year 1997. The properties we reviewed accounted for about 19 percent of the funding for all sales to priority purchasers and carve-outs on HUD's November 1996 funding queue.

To provide information on the funding provided to preservation properties as compared with their values, we used the HUD-approved preservation values, which are generally based on independent appraisals and physical inspections of the properties. We did not conduct our own independent assessments of property values for the 40 properties we examined. Essentially, the values we used represent "as is" fair market values of the properties based on their highest and best use as unsubsidized market-rate rental properties, reflecting the deduction of all improvements, repair and conversion costs needed to transition from subsidized to market-rate housing. It is important to note that these values do not take into account increases in property values that may result from improvements funded under the preservation program.

We compared the HUD-approved values with the HUD-approved financial incentives. The financial incentives were taken from HUD's final approved

funding queue for fiscal year 1997, dated March 21, 1997, for the 24 properties HUD identified for funding at that time and from HUD's November 20, 1996, funding queue for the other 16 properties that had not yet been identified for funding as of March 21, 1997. We lowered the approved financial incentives on these listings, however, for the cases in which the incentives shown on the funding queue exceeded the fiscal year 1997 funding caps, except in the two cases for which HUD had waivers pending as of May 15, 1997.

To provide information on the levels of rehabilitation grants provided to properties compared with their physical needs, we reviewed HUD's files for the 40 cases and obtained the physical needs identified in the preservation capital needs assessments performed by HUD's contractors. We compared the repair needs identified in the preservation capital needs assessments with the amounts for repairs and the repair contingency in HUD-approved plans of action for the properties. As discussed in the report, the rehabilitation costs in the approved plans of action do not fully reflect the impact of the fiscal year 1997 funding caps. As of May 1997 it was not clear how the funding cuts needed at some properties to meet the fiscal year 1997 funding caps would be allocated among equity, rehabilitation, and transaction costs. We also interviewed HUD officials in headquarters and in the field and reviewed HUD's regulations and guidance to determine the basis for the approval of rehabilitation requests.

To determine what administrative and other problems have arisen under the preservation program, we obtained information from our file reviews of the 40 cases we examined. We did not attempt to assess the extent to which each of the 40 transactions we examined was processed in accordance with preservation program requirements. We also interviewed HUD officials at headquarters and six field offices (located in Boston, Chicago, Hartford, Los Angeles, Jacksonville, and Seattle) and industry officials including representatives from the National Housing Trust, the Institute for Responsible Housing Preservation, and the Mid-City Financial Corporation. In addition, we reviewed past HUD Inspector General reports and held discussions with Office of the Inspector General officials to identify problems associated with the program and the status of any recommendations to correct them.

To identify lessons learned from the preservation program that can be applied in the development of HUD's portfolio reengineering program, we obtained comments and opinions from a wide range of officials having experience with HUD's multifamily housing programs. These included

officials in HUD's Office of Multifamily Housing Programs at headquarters and representatives from the four HUD field offices where we performed our work. We also interviewed a range of representatives from the private and public sector who were familiar with affordable housing programs. This included officials from the National Housing Trust; the National Housing Conference; the National Housing Law Project; the National Low Income Housing Coalition; the National Housing Partnership; Recapitalization Advisors Inc., Boston, Massachusetts; On-Site Insight, Boston, Massachusetts; the Community Economic Development Assistance Corporation, Boston, Massachusetts; the California Housing Partnership Corporation, Oakland, California; Emily Achtenberg, consultant, Boston, Massachusetts; the Kerry Company, Washington, D.C.; and the Chicago Community Development Corporation, Chicago, Illinois. In addition, we reviewed portfolio reengineering legislation and regulations pertaining to HUD's demonstration program and discussed the program with demonstration program officials at headquarters and its demonstration contractor group, the Ernst & Young Kenneth Leventhal Real Estate Group.

In addition, we obtained information about prepayments by analyzing spreadsheets compiled by HUD's preservation office which contained data for fiscal years 1996 and 1997 on properties for which owners had filed notices of intent to prepay as of March 5, 1997. We generally used data from HUD's multifamily housing data systems to identify the locations of these properties. We did not verify the accuracy of the location data in these systems. For information on the protections available to tenants affected by prepayments, we reviewed the statutory requirements of LIHPRHA (P.L. 101-625) and of the fiscal year 1996 and fiscal year 1997 HUD appropriations legislation (P.L. 104-134 and P.L. 104-204, respectively). We also reviewed HUD's written regulations and guidance for implementing the legislative provisions and discussed them with preservation office staff.

Comments From the Department of Housing and Urban Development and GAO's Evaluation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

July 10, 1997

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MEMORANDUM FOR: Judy England-Joseph, Director, Housing and Community Development Issues, Government Accounting Office, GAO

FROM: Nicolas P. Retsinas, Assistant Secretary for Housing - Federal Housing Commissioner, H

SUBJECT: GAO Report to Congressional Committees on the Housing Preservation Program

We have reviewed your Draft Report of the Department of Housing and Urban Development's administration of the Preservation program. Thank you for the opportunity to comment. The Department's general comments and observations on GAO's draft report are provided in this letter. Further detail and backup documentation are provided in the technical addendum.

See comment 1.

Many key issues confronting the Department in managing the Preservation program are identified in your report. We anticipate it will be very helpful to us in improving our administration of the program, and notably, in implementing the Portfolio Reengineering initiative. Nevertheless, we disagree with some of your conclusions and analysis of the program.

While your report raises legitimate management and internal control issues, and has identified isolated cases where these have had a negative impact, the conclusions unfairly characterize the Department's overall administration of the program. We disagree with your methodology and policy analysis in three respects:

I. GAO Report Overstates Program Funding Costs

See comment 2.

Your report acknowledges that the properties reviewed were not randomly selected and cannot be used to draw conclusions about all of the properties HUD has funded. We underscore and emphasize this point; your analysis was based on projects located in high cost areas, with funding amounts at the top of the range of project costs. The sample is statistically invalid and is an inaccurate reflection of both the program history and the existing funding queue of projects yet to be funded.

See comment 2.

2

As discussed and documented in the attached technical addendum, your report overstates the average total funding cost by 269 percent for Sales projects which have been funded with Capital Grants.

II. GAO Report Concludes Preservation Funding Often Exceeds Property Values Due to High Rehabilitation Costs

See comment 3.

The GAO report compares the owner's estimate of repairs provided in the preliminary capital needs assessment (PCNA) with what HUD funded at the time the project was sold to a tenant organization or nonprofit purchaser. GAO concluded that for the 27 sales projects it analyzed, HUD funded rehabilitation costs were 568 percent higher than what was needed to cover necessary repairs. We take strong exception to this conclusion for three reasons:

See comment 4.

1. Preservation value is an inappropriate basis of comparison with program cost. This value is based on the repairs estimated in the PCNA, and is not comparable to the value of the project after the POA improvements are made. While the cost of these improvements may not (or may) result in a dollar for dollar increase in value, the correlation is not reflected in the comparison of program cost with Preservation value. The GAO report notes this point, but did not change its methodology.

See comment 5.

2. The primary cause of program costs exceeding Preservation value in your sample is the direct result of an appropriate, prudent and conscious policy decision made by the Department in 1994 to encourage purchasers of Sales projects to perform improvements above those specified by the Preservation Capital Needs Assessment (PCNA) performed by the seller at the time of the appraisal. Isolated instances notwithstanding, these repairs have been appropriate and cost effective given the impact on reduced project operating expenses, property values, and likelihood affordability of the housing stock will be sustained with no additional operating subsidies.

See comment 6.

We share your concern that limited funding resources require us to be vigilant about the cost of preserving affordable housing. We agree that more stringent criteria are needed to document the cost effectiveness of proposed repairs. Nevertheless, GAO's criticism of this policy is short-sighted and ignores the effect the repairs have on the long-term future of the projects.

3

See comment 2.

3. Your analysis overstates the average per unit repair costs by 289 percent for Sales projects with Capital Grants ($28,051 in the GAO sample versus the $7,204 actual historical average). Similarly, the average per unit repair costs are overstated by 341 percent for Sales projects which used Section 241(f) loans; ($6,365 was the average per unit repair costs for those projects).

III. Reserve for Replacement Analysis

See comment 7.

We disagree with the report's conclusions and recommendations concerning the Department's policies regarding the level of Reserve for Replacement account funding.

While we believe that it is never appropriate to allow Owners receiving Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA) incentives to withdraw Reserve for Replacement funds when there is an Initial Deposit required, the policy to release these funds reflects Congressional intent. As noted in your report, the legislative history cited in your report was attached to an amendment that was not enacted, however it reflected the House Banking Committee's thinking on the issue. Subsequent discussion with Senate Appropriations Committee staff confirmed our understanding that, despite the Department's expressed reservations, Congressional intent was that these funds be released. Congressional staff took strong exception (and strenuously objected) to the Department's requirement that Owners of carve-out extension projects fund Reserve for Replacement shortfalls, stating that it was "not the intent of Congress to require Owners to fund shortfalls" in this account.

See comment 8.

We agree that the Reserve for Replacement account should not be excessively over funded. The Department has taken action to prevent over funding the account by revising its method for determining the adequacy of the existing Reserve Account and the Initial Deposit. We will continue to emphasize the need for prudent, conservative estimates of Reserve for Replacement requirements.

HUD's Response to GAO Recommendations

1. Types of improvements eligible for rehabilitation funding and HUD's reviews of request for such funding.

   We agree that, given the limits on HUD staff's capacity to process and monitor the program, the criteria for eligibility of additional repairs and improvements (above those cited in the Preservation Capital Needs

4

Assessment) was too broad. Instructions implementing any future funding will emphasize the need to document a cost/benefit analysis. We recommend more restrictive Fair Market Rents based high cost limitations as a more objective and manageable method of constraining program costs.

2. Effect of increases in rehabilitation funding on Owner equity.

See comment 9.

The appraisal guidelines are consistent with the LIHPRHA statute in specifying the Owner's equity is adjusted by deducting repairs that would bring the property to a marketable ("good") condition as an unsubsidized project, but not deducting additional improvements (or regulatory repairs). The recommendation is inappropriate.

3. Initial deposits to Reserve for Replacement accounts.

See comments 7 and 8.

The existing procedures are appropriate and necessary. They address the need to avoid "double counting" and thus over funding the account.

4. HUD Headquarters' oversight of State/Area Office activities.

See comment 10.

Should Congress appropriate additional Preservation funding, Headquarters' staff will make more frequent visits to State/Area Offices in order to monitor transactions, as well as to provide technical guidance, and to facilitate input from State/Area Office staff on programmatic issues. We do not believe that it is necessary for Headquarters' staff to review all Preservation funding transactions.

5. Owner compliance with affordability restrictions placed on properties.

We agree this issue is problematic. As recommended, we will conduct an assessment of the policies and controls in place.

6. Stop funding properties which already have long term use agreements in place and stop using Preservation funds to resolve enforcement activities.

5

See comment 11.

The Department stopped funding projects with such use agreements 4 years ago (after funding four such properties on a trial basis). We are hopeful that Congress will incorporate the recommendations in our legislative package which will strengthen our enforcement capacity and thus make it unnecessary for Preservation funds to be used for such activities.

Conclusion:

As noted in your report, the Preservation program is costly due to its inherent complexity, numerous statutory changes and overly prescriptive legislation. As in the past fiscal years, the Department does not request funds for the program. Despite numerous obstacles, the Department's administration of the Preservation program has been effective and has resulted in the Preservation of over 100,000 affordable housing units.

Attachments

Attachment 1

Technical Addendum to HUD's Response to GAO Report

Program Funding Costs

The comparison between Preservation value and project funding cost is misleading. As noted previously, while the analysis of the data in the GAO sample was factually correct, it is particularly misleading with respect to the cost of Sales transactions. Our follow-up analysis demonstrates this is true for both the historical data (those projects already funded), and for projects remaining in the funding queue. The sample selected overstates the total funding costs for the universe of projects by almost 40 percent. The effect is even more exaggerated (by 173 percent) if the total funding cost for the universe of projects funded and those in the funding queue is compared to your sample on a per project basis.

	Average Funding Cost/Unit (Sales)	Average Funding Cost/Project (Sales)
GAO Report Sample:	approx. $50,000	$7,433,333
Historical Funding Data:	$36,054	$2,013,167
Current Queue Data:	$37,080	$3,864,301

Repair Costs

Our previous memorandum detailed a number of factors affecting the sample of projects which gives a misleading picture of the Preservation program. The analysis attached to this memorandum verifies our observation that the sample was not statistically valid (due to sample size, timing, location, and program structure). Attachment 2 summarizes the available data for repair costs per unit for various types of Preservation funding. The back up "raw" data is provided in Attachments 3 through 7.

The draft report's sample overstates the average per unit repair costs by 289 percent when compared to historical funding and by 122 percent when compared to the projects in the funding queue awaiting funding. As noted in Attachment 2, the per unit repair cost for Sales funded with Section 241(f) loans (also originated after Notice H 94-42: Mid Course Correction II (MCCII), was issued) is much less than the sample.

2

	Cap Grant Average Repair Cost/Unit (Sales)	241(f) Loan Average Repair Cost/Unit (Sales)
GAO Report Sample:	$28,051	N/A
Historical Funding Data:	$7,204	$6,365
Current Queue Data:	$12,623*	N/A

* As noted in your report, the funding queue data does not reflect the High Cost limitations established by the 1997 Appropriations Act; this exacerbates the discrepancy between the actual program funding structure and any generalization which can be drawn from your analysis.

The nominal per unit repair cost for the universe of Section 241(f) funded extension projects highlights the difference in motivations between for-profit Owners and non-profit purchasers (e.g. increasing the equity basis for distributions, performing repairs prior to entering the pipeline to avoid Davis Bacon wages, etc.).

The difference in repair costs between the Section 241(f) loans for extensions pre- and post-MCCII is attributable to the larger percentage of Title II projects processed prior to MCCII. Most of the projects funded after MCCII were delayed due to disagreements between the Owners and HUD in the appraisal process concerning the extent of repairs. Generally these projects were more likely to need costly repairs than the projects funded pre-MCCII.

In summary, the data demonstrates that the conclusions regarding repair costs which would be drawn from your draft analysis misrepresent the overall financial structure and results of the Preservation program.

Procedure for Review of the Preservation Capital Needs Assessment (PCNA) and Plan of Action (POA) Repairs

Attachment 8 summarizes the State/Area Office responsibilities in reviewing the PCNA and POA repairs. Our previous memorandum provides an explanation and justification of the policy to allow improvements and repairs in the POA (beyond those specified in the PCNA). We agree that there is a need to document a cost benefit analysis to ensure that the cost of improvements and repairs are reasonable and appropriate. Instructions issued for any future processing/funding will emphasize this point. Instructions cautioning staff to not double count repairs in the Reserve for Replacement calculation are contained in HUD Notice H 96-48 (page 15), HUD Notice H 94-42 (page 15), and HUD Notice H 93-21, Attachment 1, page 14.

3

Appraisal Issues

See comment 12.

Your report questioned the $5,000,000 adjustment in value for the Alewife project. Our review concluded that the State/Area Office staff was justified in making the adjustment. It is clear that the contract appraiser misunderstood the theoretical nature of the assignment dictated by the program, lacked familiarity with the market, and refused to discuss the issues raised by the Owner's appraiser. As noted in our previous memorandum, the decision for the HUD staff appraiser to make adjustments to the appraisal was in accordance with program requirements, and appropriate giving the sensitivity of timing, and competing workload demands.

Our concern is not with the adjustment to value, but staff's administration of the Technical Discipline Contract (TDC) given the significant technical and programmatic errors. Distance Learning Training in the area of Contract Administration has been subsequently provided. Since this issue has broader implications than the Preservation program, we will continue to emphasize the importance of follow-up evaluation (and sanctions where necessary) of TDC contractors, particularly when there are deficiencies.

High Cost Limits

The report notes that processing for three projects exceeded the Fair Market Rents high cost limits. We will issue a memorandum clarifying the applicability of these limits. We have denied several requests to exceed these limits. Headquarters program staff and managers have conducted site visits, and are reviewing the processing files for two projects in which High Cost exceptions are being considered. It is unlikely any other exceptions to the high cost limits will be considered. Indeed, we recommend more stringent limits for any future funding.

Maintenance of Funding Queue

See comment 13.

The report notes that projects were added to the funding prior to receipt and approval of a Plan of Action (POA). The State/Area Office's conclusion as to the funding requirements, and submission of a Capital Grant worksheet is sufficient to place a project on the funding queue. Formal submission and approval of the POA may or may not have been granted and is not required in order to estimate the funding required (or to place the project on the queue) so long as the Office has evaluated the financial structure of the transaction and the repair costs.

The following are GAO's comments on the Department of Housing and Urban Development's (HUD) letter, received on July 10, 1997.

1. We continue to believe that the administrative weaknesses discussed in the report while not based on a random sample of HUD's properties nevertheless have hampered HUD's ability to ensure that the program is managed effectively and efficiently, that federal funds are being spent wisely, and that program requirements are complied with. Furthermore, the Department's comments on this report recognize that improvements in internal controls and procedures for program administration are needed.

2. We continue to believe that our methodology was appropriate to address the report's objectives. While, ideally, it may have been desirable to examine all of the properties scheduled for funding in fiscal year 1997, this would have involved our carrying out work in 16 HUD field offices. Such an approach was not practical given the time frames we had to perform our work and current budget realities. Instead, we focused our work on field offices with substantial preservation workloads and properties at those field offices that were likely to receive funding in fiscal year 1997 or 1998 (if the program is continued). The fact that our results cannot be statistically projected to the universe of preservation properties awaiting funding in no way invalidates our findings that the incentives provided to a substantial number of properties are high, in many cases far exceeding the properties' preservation values, and that improvements are needed in HUD controls over preservation funding. As of June 1997, in fiscal year 1997 the Department expected to fund 32 of the 40 properties we reviewed.

3. Our report shows that the rehabilitation costs funded by HUD were 568 percent higher than the repairs identified in the Department's preservation capital needs assessments which were to identify, among other things, the repairs needed to return the properties to good condition. Our review of rehabilitation costs was not intended to determine the extent to which repairs funded were appropriate and cost effective but was to provide information on the levels of rehabilitation grants provided to properties compared with their physical needs. It does not conclude that these rehabilitation costs were higher than what was needed to cover necessary repairs. Rather, our point, with which HUD also agreed, was that the criteria for improvements that may be funded under preservation is too broad in light of the limits on HUD staff's ability to process preservation funding requests and monitor the program.

4. We continue to believe that a property's preservation value was the best available measure of property value that could have been used to respond to the House Conference Report's request that we compare the funding provided to preservation properties to the properties' values. Our report recognizes that the preservation value, which is based on its "as is" fair market value as an unsubsidized market-rate rental property, does not take into account any increases in property value that may result from improvements funded under the preservation program. However, as HUD's General Deputy Assistant Secretary-FHA recognized in a memorandum commenting on the facts contained in our report, no appraisals are required that would determine a property's value after repairs and improvements are completed. Also, performing such appraisals would have been difficult, if not impossible, at the properties we analyzed, because they have either only recently received preservation funding or are still awaiting funding. Furthermore, while we in no way assert that preservation funding should never exceed a property's preservation value, we believe that it is reasonable for both HUD and the Congress to carefully examine the merits of preserving properties that require funding far in excess of their preservation value.

5. Our report already indicates that the significant growth in funds for rehabilitation needs that we identified is largely attributable to the Department's 1994 policy decision to fund improvements above those identified in the preservation capital needs assessments and HUD's desire to facilitate sales of properties to nonprofit owners.

6. The Department states that GAO is short-sighted for criticizing HUD's policy on funding improvements while at the same time agreeing that more stringent criteria are needed to document the cost effectiveness of proposed repairs. As noted earlier, our point was that the criteria for improvements that may be funded under preservation is too broad in light of the limits on HUD staff's ability to process preservation funding requests and monitor the program.

7. We believe the information presented by HUD is insufficient to support its assertion that the Department's policy decision to allow owners to keep the balances in replacement reserves reflects congressional intent.

8. The information presented by HUD does not cause us to change our view that the Department's policy and methodology for determining the initial deposits to replacement reserves are not sufficient to prevent funding excess amounts. HUD's revised policy for determining the adequacy of

replacement reserves, cited as the action taken to prevent overfunding of reserves, was put in place in 1995. We continue to believe that HUD's policies and controls over replacement reserve funding are not sufficient to prevent overfunding.

9. We believe that the Department's comments misstate its current policy covering equity adjustments (reductions) for repairs that bring a property to marketable ("good") condition. Specifically, HUD's comments do not reflect the Department's current policy, promulgated in 1995, which limits the deduction for repairs being funded at the plan-of-action stage that are in excess of repairs identified in the capital needs assessments to only those instances where owners had intentionally concealed required repairs during the preservation capital needs assessment process. As discussed in the report, this policy increases program costs to the extent that additional repairs are funded but the equity payments to owners are not correspondingly reduced. In addition, we are unaware of any provision in LIHPRHA that would preclude HUD from deducting from equity improvements funded at the plan of action stage that are also relevant to converting the property to an unsubsidized use.

10. In our report, we noted that headquarters did not conduct systematic reviews of field offices that process preservation transactions and concluded that the information reviewed by headquarters staff is insufficient to allow them to identify many of the issues and problems that arise. Therefore, the Department's commitment to make more frequent visits to its field offices to, among other things, monitor transactions if preservation funding is provided in the future is appropriate. Our report did not indicate that HUD should review all preservation funding transactions. However, we note that such reviews should provide sufficient coverage of preservation transactions to assure the Department that the program is being carried out consistent with program requirements, is being managed efficiently and effectively, and that preservation funds are being spent wisely.

11. While the Department commented that it had stopped funding properties with long-term use agreements 4 years ago, the property discussed in our report was funded in 1996. In addition, HUD's comments indicate that it was necessary to use preservation funds to resolve enforcement activities because of inadequate enforcement capacity. However, we question whether enforcement capacity was so inadequate that it required the Department to use preservation funding for this purpose.

12. As discussed in our report, HUD officials acknowledged that, ideally, a third party appraiser would have been engaged in this case, but that because of timing issues and competing workload demands, they believed the field office's action was appropriate. However, we note that there was sufficient time for HUD to contract for the third appraisal as 9 months elapsed between the time that the owner raised questions about the HUD contract appraisal and HUD's internal appraisal. It is not clear why a third appraisal was not requested at the time the large discrepancy between the owner's and HUD's appraisal was identified and the owner questioned HUD's appraisal.

13. HUD states that approval of the plan of action was not required to estimate the funding or to place a project on the funding queue so long as the office had evaluated the financial structure of the transaction and the repair costs. However, during the review, program staff told us that properties are to be placed on the preservation funding queue after field offices had approved their plans of action. The properties then receive funding in the same order in which they are listed on the queue. The fact that HUD did not consistently apply this rule allowed a few offices to obtain funds ahead of most of the other offices which submitted their properties for funding after they had approved the plans of action. In the case cited in our report, the property was placed on the funding queue on July 12, 1996, but the plan of action was not received by the field office until July 15, 1996. This raises questions about how the office would have evaluated the proposal.

Major Contributors to This Report

Housing and Community Development Issue Area	Mark H. Egger Christine M.B. Fishkin Diana Gilman Richard A. Hale Richard C. LaMore Joseph M. Raple Rose M. Schuville Leigh K. Ward
Design, Methodology, and Technical Assistance Group	Luann M. Moy
Economic Analysis Group	Austin J. Kelly
Office of the General Counsel	John T. McGrail

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