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B-208003

JUNE 30, 1982

The Honorable John C. Danforth
United States Senate



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Dear Senator Danforth:

Subject: HUD's Reassessment Procedures for Multifamily
Housing Projects During the Approval Process and
Construction Phase (GAO/CED-82-109)

In a March 19, 1982, letter, you asked us to determine whether the Federal Government has procedures to reassess its commitment to insure and provide section 8 housing assistance payments to projects when changes such as increased construction costs and high interest rates make their financial outlook questionable. You also asked if there is a point at which the Department of Housing and Urban Development (HUD) would stop construction of a project and negotiate a fair settlement with the developer.

On April 19, 1982, we briefed your office on HUD's procedures concerning these issues. We then agreed to determine (1) if the reassessment procedures were followed in approving the Park Crestwood project in Crestwood, Missouri, (2) HUD's procedures to obtain comments from local jurisdictions on proposed projects, and (3) the comments obtained from local jurisdictions on the Park Crestwood project. This letter summarizes the information provided on April 19, 1982, as well as information on the three additional issues discussed above.

In summary, we found that HUD procedures:

- Call for reassessing a project's financial viability during the approval process whenever changes are proposed affecting the project's expense and income projections or whenever HUD's commitment to insure the project is modified or allowed to terminate. HUD made two reassessments on the Park Crestwood project in accordance with its procedures.

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- Require the reassessment of a project after construction begins if a developer requests a mortgage increase or the project is reported to be in default. According to HUD officials, there has been no need to reassess the Park Crestwood project since construction began on March 1, 1982.
- Call for foreclosure on projects under construction when certain conditions occur. However, a HUD official stated that remedies are generally sought to complete projects in foreclosure.
- Require the agency to obtain comments on proposed projects from State and local governments during the approval process. HUD obtained this input, in accordance with its procedures, before approving the Park Crestwood project.

OBJECTIVES, SCOPE, AND METHODOLOGY

We made this review to determine the procedures HUD follows in reassessing federally insured and section 8 assisted multifamily housing projects during the approval process and construction phase and HUD's procedures for obtaining local government comments on proposed projects. Our review was performed in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions." At HUD headquarters in Washington, D.C., and at the HUD area office in St. Louis, Missouri, we interviewed agency representatives, examined pertinent agency records, and obtained agency regulations and handbooks concerning the procedures HUD followed in processing its insured and section 8 assisted rehabilitation projects. We also contacted the Mayor of Crestwood, Missouri, regarding the city's comments on the Park Crestwood project. Our review was made during April and May 1982.

PROJECT STATUS AND PROGRAM DESCRIPTION

The Park Crestwood project is a 204-unit apartment complex undergoing extensive rehabilitation. It is insured by the Federal Government under section 221(d)(4) of the National Housing Act, as amended (Public Law 86-372). This program insures mortgages made by private lenders and is designed to provide accommodations or rehabilitate existing housing for occupancy by low- and moderate-income families. The Park Crestwood project will also be 20-percent assisted (41 units) through HUD's housing assistance payments program for substantially rehabilitated housing under section 8 of the United States Housing Act of 1937, as amended (Public Law 93-383).

A federally insured, section 8, substantial rehabilitation project, such as Park Crestwood, is subject to two types of processing by HUD field offices. The first is the approval of the developer's project mortgage insurance application. HUD is required to review the feasibility of each project application,

including (1) construction site, plans, and specifications, (2) market outlook, (3) developer's income, expense, and cost estimates, and (4) developer's credit history. An important factor in the feasibility determination is whether the project can generate sufficient rental income to maintain its economic viability yet provide reasonable rents to tenants and a reasonable return on investment for the developer. If HUD approves the application, it issues the developer a commitment of its intent to insure the project mortgage financing, which sets forth the terms and conditions of the insurance. When a developer submits evidence of compliance with HUD's terms and conditions, HUD underwrites, or guarantees, the Federal Government's commitment, referred to as the initial endorsement of the mortgage insurance. Once HUD initially endorses the project, construction can begin. The final figures of the Government's liability are determined after construction is completed and are based on actual construction costs.

A second type of HUD processing is approval of a developer's proposal for section 8 assistance. The section 8 procedures are similar to the project mortgage insurance requirements, but they differ in some respects. For example, a developer's proposal for section 8 assistance is also reviewed for project feasibility, including an assessment of the site, the construction plans and specifications, and the market outlook. However, section 8 procedures also require HUD to ensure that project rents are reasonable compared with similar unsubsidized projects in nearby areas and that the rents do not exceed HUD-established areawide rent ceilings, called fair market rents, which are published annually in the Federal Register. Further, HUD is required to obtain comments from local governments concerning the section 8 proposal's consistency with areawide and local housing assistance plans. Project mortgage insurance and section 8 processing steps are performed concurrently whenever possible.

HUD's REASSESSMENT PROCEDURES DURING THE APPROVAL PROCESS

HUD handbook procedures 4425.1 and 4465.1 for processing mortgage insurance commitments provide guidance on reassessing the financial viability of projects whenever certain changes occur up to the time of initial endorsement. HUD handbook procedures 4425.1 require a HUD reassessment of a project whenever a commitment for mortgage insurance is to be extended or allowed to terminate. Further, HUD handbook procedures 4465.1 call for project reassessments whenever changes are proposed that will affect the project expense and income projections. According to the headquarters Deputy Director, Office of Multifamily Housing Development, and the St. Louis area office Chiefs of the Multifamily Housing Programs and Valuation Branches, Housing Division, these changes generally include:

- modification of the terms and conditions of financing, including requests for a mortgage increase;
- modifications to project plans and specifications; or
- requests to revise project rents, expenses, or other cost items.

Similarly, section 8 regulations (24 CFR 881.309 and 881.310) require that previously approved developers' proposals requesting increased rents or other changes are to be reassessed by the field office and can only be approved for

- factors beyond the developers' control which could not have been reasonably foreseen,
- design modifications approved by the field office, or
- HUD-approved changes in the methods or terms of financing.

According to HUD handbook procedures 4465.1 (project mortgage insurance) and 7420.2 (section 8) and the above officials, reassessments of the financial viability of projects generally include (1) a determination of whether proposed contract rents are adequate to meet projected operating expenses and debt services, (2) an analysis of and possible revisions to project rents, expenses, costs, and market outlook to reflect current estimates of construction start and project completion, and (3) a review to ensure that rents on section 8 assisted units meet HUD's rent reasonableness requirement and do not exceed its fair market rent limitations.

REASSESSMENTS OF PARK CRESTWOOD

Our review showed that two reassessments of Park Crestwood's financial viability were performed during the approval process and were in accordance with HUD procedures. On January 7, 1981, HUD issued a commitment to insure Park Crestwood's project mortgage financing for \$5,659,200, contingent on the developer's obtaining tandem financing at a 7-1/2-percent permanent rate from the Government National Mortgage Association (GNMA) ^{1/} and a construction loan at a 12-percent rate. On January 8, 1981, HUD approved the developer's proposal for 20-percent section 8 assistance. HUD approved the following contract rents for Park Crestwood:

^{1/}GNMA's section 8 tandem funding program supports subsidized housing by providing below-market interest rate financing on federally insured projects in specially targeted areas.

<u>Unit size</u>	<u>Section 8 assisted</u> <u>(note a)</u>	<u>Nonassisted</u>
1 Bedroom	\$330 (plus a \$38 utility allowance)	\$300
2 Bedroom	\$385 (plus a \$47 utility allowance)	\$350

a/ HUD handbook procedures 7420.2 permit substantially rehabilitated section 8 unit rents to exceed rents of comparable non-assisted units by up to 20 percent to compensate the developer for increased security, management, and maintenance costs after HUD's rent reasonableness test is applied.

The project mortgage insurance commitment was to terminate in 60 days (Mar. 7, 1981). The anticipated project completion date was December 1, 1981.

When the project developer was not selected in the January 1981 public lottery for distributing GNMA tandem funding, he asked HUD on February 25, 1981, to reassess the commitment with a 9-1/4-percent interest rate (the tandem rate was 7-1/2-percent) for permanent and construction financing and with a revised mortgage of \$5,542,000. This request, however, was revised by the lender on March 26, 1981, before HUD had completed its reassessment. The lender asked that HUD reassess the commitment to once again reflect a permanent financing rate of 7-1/2 percent but with a revised construction loan of 13 percent. A request to increase the mortgage insurance to \$5,762,200 was also submitted to HUD.

HUD performed its first reassessment of Park Crestwood's financial viability in April 1981. According to HUD St. Louis area office Chiefs of the Cost and Valuation Branches of the Housing Division and our examination of the project file, HUD's reassessment included (1) a revision of project rents necessary to support the increased mortgage request, (2) a determination that the revised rents met HUD's section 8 rent reasonableness test and its fair market rent ceilings, (3) a revision of the project expense projections and the marketing (occupancy) outlook at the revised rents, and (4) an increase in project construction costs because of HUD-recommended modifications to the rehabilitation work. The project construction was still estimated to be completed by December 1981.

HUD's reassessment concluded that the project was still viable and on May 27, 1981, HUD issued the developer an amended insurance commitment for \$5,762,200, which was to expire on July 27, 1981, and approved the following rents:

<u>Unit size</u>	<u>Section 8 assisted</u> (note a)	<u>Nonassisted</u>
1 Bedroom	\$327 (plus a \$38 utility allowance)	\$325
2 Bedroom	\$380 (plus a \$47 utility allowance)	\$380

a/ HUD's rent reasonableness test limited the section 8 approvable rents in this and subsequent processing to rents near or below those for comparable nonassisted units.

The Park Crestwood lender requested an extension of the amended commitment on July 6, 1981, to make it eligible for GNMA tandem funds available in fiscal year 1982. On July 14, 1981, the HUD area office, in accordance with instructions from HUD headquarters, extended the commitment until January 1, 1982. HUD headquarters directed the area office to reassess the project's rents, expenses, and costs to reflect a December 1981, or appropriate seasonal, construction start.

In the December 1981 reassessment, HUD determined that a maximum permissible mortgage of \$5,895,000 was feasible. The reassessment revised the project rent, expense, and occupancy projections based on a January 1983 completion date and a new mortgage debt service. Further, HUD determined that the revised rents still met the section 8 rent reasonableness test and fair market rent limitations and increased its construction cost estimates to reflect a March 1, 1982, construction start. HUD concluded that the project remained financially viable, and on December 28, 1981, issued a second amended insurance commitment for \$5,895,000, effective for 60 days, with the following approved rents:

<u>Unit size</u>	<u>Section 8 assisted</u>	<u>Nonassisted</u>
1 Bedroom	\$328 (plus a \$37 utility allowance)	\$336
2 Bedroom	\$390 (plus a \$48 utility allowance)	\$398

HUD initially endorsed the project insurance and signed an agreement to provide section 8 assistance on February 25, 1982. Project construction began on March 1, 1982.

HUD's REASSESSMENT PROCEDURES DURING CONSTRUCTION

Project mortgage insurance handbook procedures 4435.1 and 4435.2 and section 8 regulations (24 CFR 881.403) provide that once construction has started, HUD is to reassess a project's financial viability in cases where a developer requests a mortgage increase

or the project is reported to be in default. Generally, a mortgage increase can be granted to (1) correct substantial errors HUD made in the original processing, (2) make substantial changes in the approved plans and specifications, (3) compensate the developer for increased carrying charges, financing costs, and taxes, (4) compensate the developer for additional costs due to HUD's or local authorities' requirements beyond the developer's control, (5) reflect increased costs which result from changes in contractors, and (6) compensate the developer for increased construction costs due to natural disasters or relocation assistance (sec. 8).

HUD handbook procedures 4435.1 state that a mortgage increase is permissible if HUD determines the project rents will support a higher mortgage amount. Handbook procedures 4435.2 provide that mortgage insurance reassessments must reevaluate current rent, expense, and occupancy levels in determining whether the new mortgage amount's debt service is supportable. For section 8 assisted projects, contract rents on the assisted units may be increased up to fair market rent levels but are required to observe HUD rent reasonableness requirements.

The HUD St. Louis area office Chief of the Multifamily Housing Programs Branch stated that since the initial endorsement on Park Crestwood (and sec. 8 agreement execution), the developer has neither defaulted nor requested an increase in the mortgage amount or rents, nor have other conditions developed which would necessitate a reassessment required by HUD procedures.

PROCEDURES FOR STOPPING PROJECT
CONSTRUCTION AND NEGOTIATING FAIR
SETTLEMENT WITH THE DEVELOPER

HUD procedures under certain conditions call for foreclosure on projects that are in default for reasons such as a prolonged work stoppage. However, when problems develop on a project during construction, remedies of some form will generally be sought to complete the project. The Deputy Director, Office of Multifamily Housing Development stated that he is not aware of any section 8 multifamily project for which construction was not completed. He further said that once the Federal Government initially endorses the mortgage insurance and signs an agreement for section 8 assistance, it is legally liable to perform its commitments.

HUD handbook procedures 4435.2, paragraph 1-10, state that when construction is interrupted in an early stage and the project's market outlook has worsened because of reduced rental or increased expense projections, HUD should consider encouraging the lender to foreclose and convey the unfinished property to HUD. The multifamily deputy director explained, however, that in cases involving a foreclosure, HUD would probably try to complete the project so that it could be sold. The deputy director further stated that if a foreclosure occurs, HUD would be liable for a mortgage insurance claim, which could involve a substantial cash outlay.

Options to solve problems can vary, as discussed on the previous page. HUD is supposed to reassess a project's financial viability if the project is reported to be in default. Relief by way of a mortgage increase can be approved if certain conditions are met. The multifamily deputy director stated that problems such as a serious work stoppage or a contractor's leaving the job may be resolved by bringing in a new contractor. Other remedies to solve financial problems can include increasing rents and redesigning a project to a smaller scale.

PROCEDURES FOR OBTAINING LOCAL
GOVERNMENT COMMENTS ON HUD PROJECTS

HUD has procedures for State and local governments to provide input on the merits and shortcomings of developers' section 8 proposals before HUD can approve them. Under section 213 of the Housing and Community Development Act of 1974 (42 U.S.C. 1439), HUD is required to give the heads of local governments a chance to review and comment on section 8 proposals regarding their consistency with the local area's planned housing assistance needs. The legislation gives the local government the right to object to a section 8 proposal if it is not consistent with a locally approved housing assistance plan or, for areas that do not have such plans, on the adequacy of the proposed services and facilities.

Similarly, Office of Management and Budget Circular Number A-95 (as revised, Jan. 2, 1976) requires HUD to send section 8 proposals to designated State and/or local agencies, called clearinghouses, for their comments concerning the effect of the planned Federal housing assistance on other Federal, State, or local initiatives. According to the Deputy Director, Office of Multifamily Housing Development, HUD mortgage insurance programs have no similar requirements for local government review but, under certain circumstances, are subject to A-95 project coordination requirements. Pursuant to the above requirements, HUD generally allows State or local governments a 30-day period in which to submit their comments or objections.

HUD gave two jurisdictions an opportunity to comment on the Park Crestwood project proposal before it approved the project and followed its procedures in the process. On February 14, 1980, HUD sent form letters along with the proposals to St. Louis County and the city of Crestwood, Missouri. The letter requested comments, among other things, on Park Crestwood's consistency with the local (St. Louis County) housing assistance plan and invited other comments the local governments wished to make. HUD received comments from the Crestwood City Administrator on March 7 and March 12, 1980. The city replied that it had no objection to the proposal concerning its consistency with the St. Louis County housing assistance plan. However, the city raised concerns about project drainage pipes illegally connected to the city's sewer system and noted that it received complaints from tenants concerning inadequate heating systems and exterior and swimming

pool maintenance. The Crestwood City Administrator also wrote the St. Louis area office on September 19, 1980, reminding HUD of the concerns it raised in the city's March 1980 letters.

On March 14, 1980, the St. Louis County Executive responded to HUD's section 213 request. The county determined that the Park Crestwood proposal was consistent with its housing assistance plan and made no other comments. The HUD St. Louis area office Director of the Economic and Market Analysis Division and Chief of the Multifamily Housing Programs Branch, of the Housing Division, explained to us that the city of Crestwood's comments were considered but were not an impediment to the project's approval, especially because the city raised no objections concerning the housing assistance plan. The Chief of the Multifamily Housing Programs Branch said that the city's complaint about the project's drainage was corrected before HUD's section 8 approval. Further, this official stated that the developer's planned rehabilitation would address much of the city's concerns about the inadequate heating and maintenance.

On February 11, 1981, following HUD's approval of the Park Crestwood proposal for 20-percent section 8 assistance (Jan. 8, 1981), the Park Crestwood developer submitted another proposal to the HUD St. Louis area office for 100-percent section 8 assistance on the project. On February 23, 1981, HUD notified the city of Crestwood of the new proposal and requested the city's comments in accordance with its section 8 procedures. The city of Crestwood responded to HUD on the new proposal by two letters dated March 6, 1981. The city noted that the 100-percent section 8 request would be highly disruptive to the apartment complex and related neighborhoods. The city further requested that HUD not approve the 100-percent section 8 proposal and rescind its commitment for 20-percent subsidization. According to the Mayor of Crestwood, the city officials did not object to the 20-percent subsidization in their March 1980 comments because at the time it was their understanding that the city could only object if the project was inconsistent with the area's housing assistance plan. She said the misunderstanding occurred as a result of a meeting between city officials and HUD area office representatives in March 1980.

HUD's Deputy Director, Office of Multifamily Housing Development and the Area Counsel for the St. Louis area office explained that the city of Crestwood's negative comments on the 100-percent section 8 proposal and the previously approved 20-percent proposal do not legally require HUD to disapprove the Park Crestwood project because HUD already had issued the developer a commitment for insurance and 20-percent section 8 assistance. They further stated that while HUD will consider other comments opposing a project, the law only requires HUD's disapproval if the project is inconsistent with the local housing assistance plan. Further, the St. Louis area office Chief of the Multifamily Housing Programs Branch stated that the city raised no opposition to the Park Crestwood project in its March 1980 comments on the 20-percent section 8 proposal.

This official also told us that HUD did not fully process or approve the 100-percent section 8 proposal, as sufficient section 8 funds were not available for HUD to make additional commitments during fiscal year 1981. The project lender formally withdrew the request for 100-percent section 8 assistance on December 1, 1981.

HUD followed its procedures in obtaining State/local (A-95) comments on the Park Crestwood original proposal. On February 14, 1980, HUD requested A-95 comments on the Park Crestwood proposal from two clearinghouses, the East-West Gateway Coordinating Council, St. Louis, Missouri, and the State of Missouri Clearinghouse in Jefferson City, Missouri. On March 12, 1980, the East-West Gateway Coordinating Council responded to HUD that it had notified interested or affected parties and that no comments were received, and the council had no objections to the proposal. On March 13, 1980, the State of Missouri Clearinghouse responded to HUD's request. The only comments it provided were a reminder that the project must comply with State air quality laws during construction and a suggestion that a survey be made for archaeological and historical reasons. According to the HUD St. Louis area office Environmental Officer who reviewed the A-95 submissions, the Missouri Clearinghouse comments were considered in HUD's assessment of the Park Crestwood proposal, but comments of this nature normally would not be adverse to project approval.

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At your request, we did not obtain written comments from HUD or other parties. However, matters in this report were discussed with HUD's Deputy Director, Office of Multifamily Housing Development, and appropriate changes were made to the report. Further, as arranged with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from the issue date. At that time we will send copies to the Secretary of Housing and Urban Development and we will make copies available to other interested parties.

Sincerely yours,



Henry Eschwege
Director