

## **Physical Inspections**

**Lead Office: USDA-RD**

**Participating Offices:** USDA-RD, HUD-MF, HUD-PIH, HUD-CPD, HUD-OGC, Treasury-IRS

**Prepared by:** Stephanie White, USDA

### **Issue Statement:**

Today, a property that has multiple Federal funding sources may be subject to multiple physical inspections using multiple physical inspection standards. This Alignment Team was formed to see if the various Federal funding sources could reduce the frequency and number of inspections to no more than one federally-sponsored visit to each property per year. A property that has multiple Federal funding sources is the target of this initiative and is considered a 'Combined Funding property.'<sup>1</sup>

### **Proposed Alignment:**

**Alignment Summary:** The solution to reducing the number of physical inspections required by Federal funding sources is to have one periodic and regularly-occurring Federal physical inspection acceptable to all Federal funding sources and the local and State agencies to which appropriate authority has been delegated. In order to achieve this alignment, the Rental Policy Working Group propose to investigate a common physical condition inspection standard, a format of inspection results that can be utilized by each Federal funding source, an acceptable inspection frequency, and an acceptable sample size (number of units to be inspected). Achieving alignment in all these areas may not be possible for all programs, and alternatives are presented for consideration.

Although this alignment effort may be achievable in the global context, each department maintains different enforcement standards based on physical inspection findings, and enforcement standardization is not being proposed. Each agency still retains the ability to follow-up on any compliance issues with subsequent agency-specific inspections or actions, as permitted by loan or business agreements and Federal regulations.

**Specific Actions to Effect Alignment:** One periodically-scheduled physical inspection performed by one agency for the benefit of Federal agencies with a vested financial interest in that property will create efficiencies for the government, for property owners, and for residents of affordable housing whose apartments are subject to inspection. Alignment may be achieved by the following, which will be pursued in sequential order. (Once the results from the pilot program are in hand, a decision will

---

<sup>1</sup> The entire universe of Combined Funding properties are those that combine any number of federally-sourced subsidy or tax credit programs, including LIHTC, USDA-RD programs and loan guarantees, as well as HUD programs like FHA insurance, CDBG, HOME, HOPEVI and PBRA (State and Federal level). Data related to a subset of this universe of properties (i.e., those properties for which the LIHTC is combined with any number of other Federal programs, including USDA-RD and HUD programs) is sourced from HUD-PD&R, at <http://lihtc.huduser.org>.

be made whether alignment in these ways for HFAs should be promulgated as recommended best practices or in some stronger fashion.)

1. Alignment of inspection standards:
  - A. Use of the Uniform Physical Condition Standards (UPCS) protocol as the common inspection standard for on-going physical inspections on aligned properties for the LIHTC, HOME, Rural Development, Public Housing, project-based Section 8, Section 202 and Section 811 and FHA-insured Multifamily programs; Or
  - B. Use of the Uniform Physical Condition Standards (UPCS) or local code, whichever is more stringent, as the protocol and the common inspection standard for on-going physical inspections on all properties that have units supported by HOME funds. The Housing Choice Voucher Program (HCV) uses Housing Quality Standards which differ from UPCS and local code;
2. Use of a statistically valid sample size from all assisted units in a building on aligned properties;
3. An established inspection frequency of not less than every three years, providing for the flexibility that each participating Federal, State or local agency may need to do more inspections depending on inspection findings (e.g., risk-based scheduling of subsequent inspections) and non-compliance issues. A review at least every three years ensures prudent but not intrusive oversight.

Current Status: One area where Congress has already initiated the standardization effort is the Housing and Economic Recovery Act of 2008 (HERA). The Act states that if the tax credit allocating agency (HFA) is already performing periodic inspections on a multifamily property with an FHA-insured mortgage, no such inspections need be done by the mortgagee. However, HUD has not yet completed its rule-making process for implementing this provision.

In addition, there is already some alignment between programs that could be formalized by this standardization action:

- For example, HUD's Real Estate Assessment Center (REAC) which covers HUD-PIH<sup>2</sup> and HUD-MF<sup>3</sup> programs, and State housing finance agencies (HFA) which perform physical inspections for the Low Income Housing Tax Credit (LIHTC) program, do or can use UPCS as the basis for their inspections<sup>4</sup>.
- USDA-RD accepts third-party inspections, so alignment with HUD and Tax Credit programs is relatively straightforward.
- Under § 1.42-5(d)(3) of the Income Tax Regulations, a State HFA is not required to do a physical inspection of a LIHTC property if the building is financed by USDA-RD under the Section 515 program, USDA-RD inspects the building, and the State HFA and USDA-RD enter an agreement for USDA-RD to notify the State HFA of the inspection results.

---

<sup>2</sup> Public Housing and properties with project-based Section 8 assistance including Housing Choice Vouchers.

<sup>3</sup> Multifamily properties with FHA-insured mortgages.

<sup>4</sup> HFAs may also use local health, safety, and building codes for the LIHTC program.

- Under § 1.42-5(d)(4), a State HFA agency may delegate inspection to an Authorized Delegate, which may include HUD or a HUD-approved inspector. The utilization of UPCS as an accepted standard for such projects is logical since it forms the basis for most inspections now. However, utilizing UPCS raw data does pose a problem for HUD programs that score projects under the REAC system, which is discussed more fully below.

Future Alignment: This alignment effort covers a multitude of programs, mostly at HUD, with varying standards, sample sizes, and frequency requirements. Some programs are project-based, meaning they cover all units in all buildings of a development; and some programs are unit-based and cover only some units in some buildings of a development. Due to the differing scales of programs, alignment across every program may not be possible. However, in an attempt to identify which agency might perform the inspection on aligned properties and provide results to other agencies, the following chart was developed:

<b>Aligned Property Type</b>	<b>Lead Inspection Agency/Protocol</b>
HUD-MF/PIH properties	HUD/UPCS-REAC
Tax Credit properties	HFAs (using local code)/UPCS
Rural Development properties	USDA-RD
HUD-MF/PIH + Tax Credit properties	HFAs/UPCS with uniform format
HUD-MF/PIH + USDA-RD	HUD/UPCS-REAC
Tax Credit + USDA-RD	HFAs/UPCS or USDA-RD
HUD-MF/PIH + Tax Credit properties + USDA-RD	HFAs/UPCS with uniform format
HOME + Tax Credit properties	HFAs/UPCS or local code, whichever is more stringent
HOME + USDA-RD	To Be Determined
HOME + HUD-MF/PIH +/- Tax Credit +/- USDA-RD properties	To Be Determined
HUD Project-Based Vouchers	To Be Determined

Generally, agencies will follow their own inspection protocols on non-aligned properties. For example, Rural Development will continue utilizing its current physical inspection protocol on non-aligned properties with only RD financing. However, if an RD property should receive the benefit of tax credits or a project-based Section 8 subsidy contract, the physical inspection protocol on that property would ideally change to the common standard, with inspections conducted by either the State HFA or HUD, as USDA-RD lacks the financial resources to train and certify field staff in the

UPCS standard. In addition, given the relative remote location of many USDA-RD properties, it may not be practical to find other certified UPCS inspectors. This would ensure that the 'one scheduled physical inspection' solution is maintained.

In order to establish MOUs that would allow one agency to take the lead as the inspecting agency on aligned properties, there would need to be adequate guidance for the field staff of Federal agencies and for the State HFAs.

### **Resource Estimate for Implementation**

Uniform Reporting Format: HUD's Public Housing, project-based Section 8-assisted housing, and Multifamily housing programs currently use a highly automated system to manage their inspections and processes, the Real Estate Assessment Center system (REAC). This system utilizes UPCS inspection standards at its base level, but also involves the interpretation of UPCS inspections into REAC-designated scores. This proposal will allow for options to be selected by the inspecting agency, yet due to the broad reach of UPCS and REAC, the Rental Policy Working Group suggests either of the following:

1. Use of the UPCS inspection standards by non-REAC inspectors that could be inputted into or "read" by HUD's REAC software system, so that the inspection results could be scored according to HUD's REAC protocol. The Team proposes adopting a common set of criteria that would ensure that all UPCS inspectors that inspect aligned properties are competent to perform the type of physical assessment required.
2. The REAC training and software protocols could be required of all UPCS inspections on federally-assisted properties, i.e., whenever UPCS is used, it would be a REAC inspection. In order to support this adoption, HUD-REAC will make available training webcasts. This adaptation will enable the Rental Policy Working Group to test these alignments in the context of a pilot, where participation is voluntary.

Once the results from the pilot program are in hand, a decision will be made whether alignment in these ways for HFAs should be promulgated as recommended best practices or in some stronger fashion.

The Physical Inspection alignment proposal denotes that UPCS will be the common inspection standard, but does not require that the REAC system be used. This poses a challenge for HUD programs that utilize UPCS and other data to score a property under REAC. The uniform UPCS inspection format could be based on a paper inspection form or on an electronic (XML) form.

The costs associated with processing the inspection data and the costs of developing/modifying REAC's databases so that non-HUD related data can be managed separately would largely be upfront to HUD. HUD estimates that the development costs for this initiative are estimated at \$1,080,000 and could not be completed until April 2013 at the earliest. Costs for an "all-REAC" alternative would incur to both HUD and stakeholders who pay for inspections, such as HFAs.

System modification is a lesser cost than development of another input or processing method, and involves a shorter timeframe. In summary, the money/time cost of these alternatives is:

- Modify software/systems to expand the universe - \$120,000 / 18 months
- Create an alternative input/processing method - \$1,080,000 / 24 months

Establishing a common set of quality assurance criteria for all UPCS inspectors as an alternative to a REAC certification would have a cost associated with it, for which a funding source or sources would need to be identified. If the certification criteria mirror generally accepted criteria in the industry, however, this premium would be de minimis.

The average cost of a REAC inspection in FY2010 was \$396 per inspection. For costing purposes below, that figure has been rounded to \$400 per inspection.

Most inspections to be conducted by HFAs: This proposal recommends that the State Housing Finance Agency be designated as the lead inspection agency in most multiple funding situations. The LIHTC program is today's primary source of financing for new or rehabilitated affordable housing units and the dollar-size of the investment is several times that of other financing provided by HUD or USDA-Rural Development. HFAs conducting the majority of these inspections results in Federal government cost savings, but also is a natural extension of the HFAs' fiscal responsibilities under Section 42 of the Internal Revenue Code. As of 2007, the universe of properties with multiple Federal funding sources is detailed below. Based on this information, the three agency entities in each State would have performed 22,546 separate inspections on 10,485 properties.

Number of Program Subsidies in addition to LIHTC	Total Inspections		
	Properties	x Subsidy programs	Low-Income Units
Tax Credit Properties with No Subsidy	27,594		
1 Other Subsidy Program	9,177	18,354	645,924
2 Other Subsidy Programs	1,081	3,243	79,366
3 Other Subsidy Programs	187	748	12,066
4 Other Subsidy Programs	35	175	2,470
5 Other Subsidy Programs	4	20	386
6 Other Subsidy Programs	1	6	10
<b>TOTALS</b>	<b>10,485</b>	<b>22,546</b>	<b>740,222</b>

\* Other subsidy programs include only Tax-Exempt Bonds, HOME, CDBG, HOPE VI, USDA 515, Project-Based Rental Assistance (Federal and State), and FHA insurance. Excludes properties no longer monitored for program compliance. Chart includes only properties placed into service through 2007. For more information see: <http://lihtc.huduser.org/>

Inspectors (Training or Contractors): HFAs may elect to use their own staff to conduct these inspections or use outside contractors. Some HFAs will choose to train inspectors in the UPCS standard. There is no cost for this training; however, at this time, the course is offered only in

Washington, DC as a one week course with a certification exam. All expenses (travel, lodging and per diem) are solely borne by the participant. An online version of the training is still being developed but will not be available until 2012. Separately, there is no charge for use of the REAC software. The cost to participating HFAs would likely include any premium paid for inspections by contractor inspectors who have completed REAC training and who have invested in REAC compatible computer hardware.

On-Going Dedicated Staff Resources: Each agency involved in this implementation – not just the three departments at the Federal level but also Participating Jurisdictions (PJs) and State HFAs – will need to dedicate staff resources to serve as an agency liaison to ensure implementation and continuation of this proposal. These responsibilities would entail problem resolution, ensuring inspections are conducted in a timely manner, and that inspection report data is shared among the agencies within a specified timeframe. Although not a full-time job, it will be a commitment on the part of each agency to maintain the flow of communication and be alert for potential reporting problems. Ideally, agencies should identify two people per agency who have responsibility for this effort. It is estimated that these liaison duties may constitute 8-16 hours per month for most agencies.

#### **Estimated Cost Savings to Owners, Operators, Developers, Investors and/or Lenders**

Extrapolating from data compiled by PD&R, in 2007, an estimated 22,546 separate inspections took place on an estimated, current national universe of 10,485 properties. Per industry estimates of the cost of a Federal physical inspection for their properties, at an estimated cost of foregone staff time of \$2000/inspection<sup>5</sup>, costs for 22,546 duplicative inspections could total up to \$45 million per year, nationally. By conducting aligned inspections, savings realized within one year would be up to approximately \$24 million.

Additionally, agencies may choose to further pursue a future reduction in the frequency of inspections. Over three years, there is an estimated duplicative inspection cost of \$135million. If the proposal to perform one Federal inspection every three years on each Combined Funding property (at a cost of \$24 million for an estimated, current national universe of 10,485 properties, per year) proceeds, it may result in savings of approximately \$111 million over three years from the current non-aligned costs, and an additional \$48 million over three years from an aligned inspection schedule of one inspection per year. Although these savings will not necessarily be reflected in reduced rents, they will lower expenses at the multifamily property.

#### **Estimated Cost Savings for State, Local and Federal Governments**

Utilizing the proposed inspection protocol will result in cost savings at the government level generally by a reduction in the number of inspections. These savings will be realized in the reduction of staff time out

---

<sup>5</sup> Estimates for cost of inspections based on assumptions made in the Housing Development Center study in Oregon

of the office, savings in travel expenses, and savings in contractor cost if inspections are conducted by an outside contractor.

Extrapolating from data compiled by PD&R, in 2007, an estimated 22,546 separate inspections took place on an estimated, current national universe of 10,485 properties. Based on the estimated Federal cost of approximately \$400 per inspection, the cost of duplicative inspections required on properties with multiple Federal funding sources is approximately \$9 million per year. Alignment of these inspections so that one inspection is performed on each Combined Funding property per year would result in approximate savings of \$4.8 million in one year. Additionally, if agencies choose to further pursue a future reduction in the frequency of inspections to once every three years, savings realized at the end of a three year period would be approximately \$22.2 million from the current non-aligned costs and \$9.6 from an aligned inspection schedule of one inspection per year.

A percentage of these properties will require more frequent inspections to ensure that corrective action was taken by the owner or to follow-up on compliance issues. In order to estimate this percentage, the Team considered that seven percent of properties scored less than 60 on recent REAC inspections and required a follow-up inspection. Assuming a similar percentage of owners would require re-inspections of their properties, it is estimated that this would reduce savings to governments by \$293,600 per year.

#### **Challenges to Effecting Proposed Alignment:**

Agreement from all HFAs: The LIHTC program has given substantial latitude to HFAs to carrying out the administration of the program. As such, implementation of the proposed standard protocol will require individual agreements with each HFA. In order to better understand the complexities that overall implementation may face, the Team is undertaking a pilot program with several HFAs to determine obstacles or complications in implementation of alignment.

Development of a Model Memorandum of Understanding: There are several versions of Memoranda of Understanding (MOU) that are currently in use among various agencies in several States, including the full-scale alignment of USDA-RD and State HFAs. The Team proposes development of a standard model that can be used with all States, HUD, and USDA-RD. Such an MOU would provide details on specific performance (format, sharing, timeliness, re-inspections, agency actions as a result of inspection findings) and remedies if data is not shared timely.

HOME Involvement: Additionally, when funding combined-funding rental projects with HOME dollars, HUD-CPD encourages HOME PJs to determine whether it can voluntarily align with the property inspection standards and (frequency) schedules for the project with other funders. In determining the feasibility of a voluntary alignment, the PJ must consider whether its ongoing property standard and maintenance requirements for HOME units meet or exceed the requirements of other funders, and remain cognizant of its obligation to repay HOME funds invested in noncompliant properties that cannot be remedied.

Privacy Issues: The Team suggests that it may be necessary to obtain a release from property owners to share the property data among agencies. The Team believes Federal agencies' General Counsel(s) should make a determination whether this is needed.

Regulatory Challenges: The Team found two potential regulation challenges:

- Immediate waivers of current regulations for properties participating in the pilot programs and
- A regulatory challenge in selecting a representative sample of assisted units for inspection from properties that multiple sources of Federal assistance supporting different units in a project.

Properties that participate in the pilot would need regulatory waivers for the three-year inspection requirement which may differ from current practice. In addition, if there are other actions taken as a result of using the proposed protocol, the property should be held harmless by the funding agencies while the pilot is active. Most of these issues cannot be determined at this time, but would become evident as the process and pilots evolve.

At present, for example, HUD selects a random sample from project-based section 8 units while an HFA would inspect 20% of the LIHTC units. Deficiencies found in a sample of section 8 units may not support enforcement action on LIHTC units, and vice versa. One possible solution for inspecting properties with non-overlapping assistance on different units would be to select a statistically valid, random sample from the total of federally assisted units, and only in the case of observed deficiencies, would further inspection be required. A second possible solution would be for the UPCS inspector to inspect according to each agency's sampling standard. For instance, in the case of a property that contains both LIHTC and project-based section 8, the inspector would have to inspect enough project-based units to satisfy HUD's requirements and 20% of all LIHTC units. Each Federal program would reserve the right to do additional inspections using a different sample of units if compliance issues were discovered as a result of the first inspection. Alternatively, HUD, IRS, and USDA could institute regulatory changes such that a compliance issue found in a statistically valid sample of all federally-assisted units would apply to each assisted unit, regardless of funding source, and thus each agency would be authorized to take enforcement against the units assisted under its program (even if those units were not the actual units inspected).

Cost Challenges: Cost and timing challenges were outlined above under Resource Estimate for Implementation.

Procedural Challenges: In addition to the regulatory challenge, there may be a procedural challenge in selecting a representative sample of assisted units for inspection from properties that combine Federal funding sources that require differing processes for obtaining statistically valid samples. For example, performing one inspection that covers a statistically-valid sample of LIHTC units, a statistically-valid sample of Section 8 units, and a statistically-valid sample of RD units for a property for which these three sources of funds were combined would involve one inspector coordinating



and processing data about which units in a project fall under each program and creating the valid sample for each grouping. The Team believes consistent data sharing with the lead agency for the project's inspections will be required (in the MOUs and in practice) in order to ensure that a valid sample of each program's units are inspected. The Team recommends that a valid statistical sample of all units be used as the basis for selecting units for inspection.

### **Schedule for Alignment Implementation**

The Federal agencies should create a model MOU among State HFAs, HUD and USDA to agree on the lead agency that will perform the inspections and how inspection data information will be shared. The MOU should be developed timely but no later than 60 days following approval of this proposal.

During the time that the MOU is being developed, individual program guidance for participating agencies can be developed, which is generally limited to regulatory changes. These could be accomplished according to each Department's regulatory schedule.

As the MOU and individual agency guidance are being finalized, a pilot program should be started with several States to determine the viability of the proposal and identify implementation obstacles. Team members and points of contact at HFAs, HUD and USDA-RD should adopt a short-term agreement on pilot program parameters. The Team proposes a model agreement to be used by all pilot States. The model would be similar to agreements already in place in some States among participating entities. The Team believes a pilot program could be underway during June 2011. For inspections, the pilot should cover a six month period. During the pilot period, the agencies' MOU and regulatory changes could be completed. Following the end of the pilot, the Team expects a three-month period in which program guidance would be finalized for dissemination to all field staff for HFAs, HUD and USDA.

Once the MOU among Federal agencies and participating HFAs has been signed, several programs can begin alignment implementation immediately:

- HUD-MF/PIH + USDA-RD
- Tax Credit + USDA-RD
- HOME + Tax Credit Properties

On a longer-term implementation schedule, the following programs can be more properly aligned over a period of time:

- HOME + HUD-MF/PIH
  - HUD-MF/PIH + Tax Credit Properties
- HUD-MF/PIH + Tax Credit properties require approximately 24 months to be aligned on one format for UPCS inspection that can be used by all programs.

### **Purpose**

This document is part of an ongoing effort to better align Federal rental policy across the Administration and is sponsored by the Rental Policy Working Group. The Rental Policy Working Group is composed of the White House Domestic Policy Council (DPC), National Economic Council (NEC), Office of Management and Budget (OMB), and the U.S. Departments of Housing and Urban Development (HUD), Agriculture (USDA), and Treasury.

The specific areas of concern identified herein emerged from July 2010 stakeholders gathering at the White House on areas of Federal rental policy inconsistency across the administration. The revised conceptual proposals for alignment articulated within this report are preliminary in nature and have not been endorsed by any Federal agency or office.

With any questions, please contact the Rental Policy Working Group Agency Alignment Leads: Larry Anderson, Director of Multi-Family Housing Preservation and Direct Loans at USDA-Rural Development, Ben Metcalf, Senior Advisor at HUD's Office of Multifamily Housing Programs; or Michael Novey, Associate Tax Legislative Counsel in Treasury's Office of Tax Policy.