evaluation report:

MULTIFAMILY FAILURES

Conclusions and Recommendations

Prepared by: Berkeley Planning Associates
for the Department of Housing
& Urban Development, Region IX

July 1975

Volume III

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Development, Region IX, Office of Program
Planning and Evaluation. July 1975

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Contract H-2148

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PREFACE

This report concludes our study of financial failures in multifamily subsidized housing projects built under the 221(d)(3) and 236 programs with a synthesis of the conclusions spelled out at length in previous reports and recommendations for future actions. The problems of failure in subsidized housing programs are complex and intractable. No simple solutions are likely to be found. Nevertheless, the need for adequate housing for low and moderate income families, which is the purpose of these Federal government programs, will not disappear, nor will the desire of the construction industry to build them. In one form or another, efforts will continue to be made to provide standard quality housing for those unable to afford what the private market will supply. The programs covered in this evaluation represent one strategy toward that objective. The fact that the evaluation has been done during a moratorium on most of those programs that has continued through a dramatic downturn in national construction activity, reflects a pervasive sense of dissatisfaction with the programs' performances. Therefore, this report not only considers specific factors that might affect program performance, but also looks at the strategies themselves as they are manifested in the experience of projects. While any operating agency must struggle to deal with the continuing problems of proper management, from time to time basic questions of viability of programs must also be asked. For HUD, this may be such a time.

No study such as this one can be effectively done without the cooperation and assistance of many people. We want to thank the directors and staff of the HUD Area and Insuring Offices for their direct help in the case studies and responses to the findings of the reports. Sponsors, developers, builders, managers and tenants gave their time and insights for our interviews. The staff of the Region IX Office of Evaluation, especially Peter Clute, Vicki Elmer, Judy Morton and Conrad Egan, have been supportive and rich in creative suggestions for improvement. Roger Montgomery and Chester McGuire read and made helpful comments on the case studies. Norma Montgomery typed the reports with her customary speed and high quality and Joan Collignon supervised production. This final report is based on the work of all BPA staff who have participated in this study -- Frederick Collignon, Richard Dodson, Dennis Keating, Elizabeth O'Hara and Thomas Vitek. Responsibility for the judgments and conclusions in this report remains with the author.

I. SOURCES OF FINANCIAL FAILURE IN MULTIFAMILY SUBSIDIZED HOUSING

Why do projects fail? The question is perplexing to anyone who has looked carefully at two projects, located in the same area, similar in design and construction, occupied originally by similar families, yet, after only a few years, dramatically different in physical condition, social behavior and financial viability. One is a good residential environment, the other is dilapidated and half-empty. Everyone involved, from tenants to mortgage bankers to Federal officials, has explanations and proposals. But none of the explanations can account adequately for the failures, and every proposal draws opposition from other participants in the complicated business of providing subsidized housing. The only indisputable fact is that increasing numbers of projects continue to default and are foreclosed. Over 20% of the three-quarters of a million units of Federally insured subsidized 221(d)(3) and 236 multifamily housing in the U.S. are in projects that have defaulted on mortgage payments at some time. More will fail in the future.

When a social phenomenon occurs at this scale, it presents severe problems of understanding and interpretation. Since failure is so widespread, it seems almost certain that there must be pervasive causal factors at work to explain its incidence. By comparing projects that fail with others that do not, we should be able to identify the predominant causes and move to remedy them. But, paradoxically, if the phenomenon is widespread, it may also be due to structural characteristics of the programs and the economy and society in which they function. These characteristics make up the framework in which <u>all</u> projects function, successes and failures alike. They may reflect conditions in which some proportion of projects are <u>likely</u> to fail, probablistically, with little possibility of determining ahead of time exactly which projects <u>will</u> fail. An analogy here might be automobile accidents, the causes of which are so deeply enmeshed in a motorized society as to be virtually inseparable from that society itself. To analyze the structural "causes" of housing failure is extremely difficult, for in this situation no experiential data exists for alternative structural conditions within the U.S. We may imagine the affect of alternative structures, as a fish might imagine life on dry land, but we do not have the resources to experience or measure them.

Most program evaluations proceed as though the first condition holds true; that cause and effect relationships are identifiable and measurable within the range of information that can be gathered. But if the problem we face is structural as well as behavioral, understanding and evaluation must inevitably go beyond the relationships revealed by empirical analysis, to interpret them in ways that can ultimately be accepted or rejected only through judgment. An axiom of cost-benefit analysis states that changes in the fundamental value and social structures of a system cannot be subjected to a cost-benefit calculus, for there is no continuing basis for valuing before and after the change. Nevertheless, such choices as nation modernization are made. Similarly, a social problem whose causes are structural cannot be analytically and empirically explained in terms of factors within the structure. Nevertheless, it can be discussed; arguments about structural characteristics can be developed; and decisions will be made.

It is our contention that, in large part, the "causes" of financial failure in multifamily housing are structural. They are inherent in the strategies for providing adequate housing in this society for people who could not otherwise afford it, and in the economic, social and institutional structures through which those strategies are played out. This is not to say that nothing can be done. In the first place, structural characteristics are not all equally important or necessarily unchangeable. Some institutions can be changed and new ones can be invented. Second, some part of failure can be attributed to factors that do vary systematically within the housing system as it now exists. These variables can be addressed incrementally with some prospect of success. Nevertheless, we should not be blind to the possibility that financial failure of a substantial proportion of subsidized projects is inherently likely in the present framework, and that it may be expected to continue and even accelerate in future.

Because of the difficulty of establishing a quantitative, empirical basis for discussion of structural causes of failure, the remainder of this section is divided into two parts. The first part recapitulates in summary the findings of earlier reports focusing on the effort to isolate specific cause-effect relationships from statistical analyses and case studies. The second part sets out arguments about the framework within which subsidized housing programs have operated in the U.S. and discusses alternative strategies for its provision. It is intended to provide a strategic conception within which the detailed results can be interpreted.

Factors Associated with Financial Failure

Specific factors identified in the case studies and statistical analysis are the focus of this section. They have been described in detail in previous reports and will be reviewed here in summary. The discussion is organized according to the classification of variables used throughout the comparative statistical analysis of the project sample. The judgment that a variable is associated with failure is based on its statistical relationship with alternative failure measures, both singly and in conjunction with other variables, and on the assessments derived during the case studies.

General Findings. Before we review the effects of specific factors, some general findings should be discussed. The striking result of these analyses, and a principal reason why we believe structural causes to be important, is the absence of strong statistical relationships with failure for individual factors or clusters of them in combination. Even when we make allowance for data problems and the fact that the variable to be explained, failure, is dichotomous, the correlations are generally quite weak. However, in some cases moderate but consistent relationships were observed. These variables are the building blocks for models of failure and appear to be weakly additive in effect when simultaneously related to failure.

Besides looking for explanatory or causal variables, the analysis also sought to compare their effects on different types of projects, distinguished by sponsorship and regional location. Substantial differences emerged, both in the significance of variables and their degree of influence in different subsamples. Generally, the ability of the statistical models to predict failure was stronger for the subsample of non-profit sponsored projects than for limited dividends. In part, this might be a statistical artifact related to the higher incidence of failure in the former group. However, the case studies also suggest strongly that limited dividend sponsors have greater financial resources to resist failure and a strong tax related motive to employ those resources at least to postpone it under adverse conditions. The high levels of negative cash flow among limited dividend projects, for example, suggests that variables that might be significant for failure can occur extensively among those that have not (yet) failed. The statistical data provided little information on this question. A few significant variables were clearly different between the two samples. They are discussed in the specific findings below.

The second distinguishing category employed was location by region, the 618 project statistical sample being drawn from Section 221(d)(3) and 236 projects in Federal Regions III (Philadelphia), VI (Houston) and IX (San Francisco). Again, substantial differences were found, but could not be checked against case studies because our budget limited cases to Region IX. However, they are consistent with the perceptions of regional HUD officials. Two results are worth noting. First, the regions differed strongly in the degree to which the models were able to explain failure. Regions III and IX exhibited a relatively high degree of explanation; Region VI was always lower. Furthermore, the relative significance of variables differed among regions. The performance of models at the regional level was everywhere superior to their equivalents using the total sample. We conclude that in addition to broad structural factors in the program, there are factors at the regional level that cause differences in performance. This finding is consistent with the conclusions of the most extensive study of mortgage failure in the private market.*

Indicators of Financial Difficulty. Although indicators of financial difficulty are not, properly speaking, contributing factors to failure, they are important in two respects. First, direct symptoms of difficulty, such as negative cash flow, may be leading indicators for default and foreclosure and assignment, the measures of failure used in this analysis. As such, they are important as potential means for monitoring the onset of failure. Second, symptoms of difficulty that are also attempts to respond, such as modification of principal payments or waivers of payments to replacement reserve, are significant as indicators of the effectiveness of current remedies.

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*See John P. Herzog and James S. Earley, Home Mortgage Foreclosure and Delinquency. New York: National Bureau of Economic Research, 1970, pp. 52ff.

Among both groups of variables, the degree of association with ultimate financial failure is substantial, but not overwhelming. Responses to financial problems appeared to correlate much more strongly than direct indicators such as negative cash flow. Although failed projects have negative cash flows, so do many others, so many in fact that interpretation of negative cash flow as the leading indicator would suggest that the program faced much future failure at the time of data collection in 1973. Since that time, this possibility has been realized.

Two conclusions can be drawn from these results. First, difficulty indicators may be very useful as means for monitoring performance and anticipating the near-term onset of failure. Second, the high correlation of responses to difficulty with eventual failure suggests that the responses are insufficient and applied too late, tending to postpone failure rather than prevent it.

Locational Environment. Three types of variables comprise this grouping: location of a project within a metropolitan area, i.e., urban core, ring or suburban; the characteristics of its neighborhood, including physical attractiveness, safety, and whether it is an urban renewal area; and the location of the project in relation to other potentially competing conventional or subsidized housing projects. All have been hypothesized to be important contributors to failure, and all are well established before failure occurs.

Statistical analysis revealed strong relationships with only a few of these variables. The quality of physical environment and neighborhood safety correlated negatively with failure, especially for limited dividend projects. These variables were also generally significant when other factors were simultaneously accounted for. The effects of other locational characteristics, such as intrametropolitan location or competing projects, were either undetectable or marginally converse to expectations. Case studies throw some light on these surprising results, especially for intrametropolitan location. Although a large proportion of projects have suburban locations, it is clear that a site in the suburbs does not necessarily mean a pleasant or favorable location.* Repeatedly, we encountered projects built

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* Subsequent work by the HUD San Francisco Region IX Office of Evaluation indicates that much finer locational effects are important to the success of rehabilitation projects.

in marginal suburban locations, often inaccessible, without adequate public transportation and with poor physical environments. Many expanding metropolitan areas have such enclaves within their suburban rings; often they are also the scene of widespread single-family mortgage failure and abandonment. Such areas are surely the easiest place to locate minority people and subsidized housing without opposition and they have much undeveloped land that can be inflated in value. Their attractiveness to the eventual residents is another matter. A suburban dream, they are not.

Social Characteristics and Problems. Under this heading, we include variables that are indices of a project's social integration and functioning. Not included are the social class, demographic or ethnic makeup of the residents, which are considered separately below. Rather, we are concerned with indicators of behavior and performance, the social climate. This is difficult to measure but very important. A successful project depends to an extraordinary degree upon implicit cooperation among tenants and between tenants and managers. The difficulty of conceptualizing and finding variables that describe social functioning is compounded by uncertainty as to their causal role in failure. Most of the statistical social variables on failing projects refer to a condition at the time of data collection. In many cases, we do not know whether any particular variable had been present before failure occurred, whether it was in fact a cause or an effect. However, if there is no significant relationship, we may reasonably infer that a variable was neither.

Among the statistical variables, vandalism and vacancies (the latter indicating tenant dissatisfaction), were among the most significant factors to emerge from the analysis. Whether cause or effect, and the dynamics of failure suggest that they are both, these factors play a major role in a project's demise. Not included in the statistical data, but strongly evident in the case studies are the compounding effects of tenant hostility, crime and delinquency. If management evicts troublemakers in an effort to reestablish control without building genuine community, it can do so only at high costs in rent loss, damage to vacant apartments and employment of security forces. All this may be to no purpose if the only tenants who can be attracted are essentially similar to those who left.

These problems are intensified by the lack of social services and recreation, especially in remote projects. No money was left in project budgets for social services -- day care, play supervision, boys' clubs, youth and adult physical recreation, adult education, employment and health services. Most limited dividend sponsors and some non-profit sponsors simply do not want to be burdened with additional costs for facilities and services. The programs do not require them and sponsors argue that services are the responsibility of others, especially local governments, housing being enough of a headache in its own right.

Yet, many subsidized projects, especially those with rent supplement leased housing (Section 23) have concentrations of low income families with children who especially need facilities and services. In the case studies, the reduced level of vandalism associated with services for teenagers and a high level of community was striking. These needs are recognized, for different reasons, in projects for the elderly. Services for the young may be more costly but no less necessary in marginal projects.

Project Design and Physical Characteristics. Statistical analysis of the project sample revealed little or no systematic relationship between financial failure and variables measuring population or dwelling unit density, project scale and design. And although the case studies did suggest that poorly conceived project designs can exacerbate problems of operation, maintenance, vandalism and security in projects, we cannot assign to design in the cases studied the dominant role in the social functioning of high and low-rise housing suggested by Oscar Newman and others. Most disturbing among the design variables is the general lack of open space and facilities for children and juveniles' recreation. The reluctance of developers to see recreation as part of the task of housing is understandable -- it costs a great deal -- yet the evidence in these cases suggests that lack of recreation will raise maintenance costs in a low or moderate income family project as surely as if the builder left the roofs off. The cost tradeoffs involved need to be investigated in more detail. Clearly, physical facilities alone are not necessarily enough. But they are necessary.

On the other hand, both statistical analysis and case studies indicated that the quality of construction was indeed important. Serious construction defects, coming to light in the first years of a project's operation, may well tip it into permanent financial crisis. Although contractors can be held accountable for latent defects in the construction of projects revealed in the HUD nine-month and twelve-month inspections, the needed repairs are not necessarily made. Some contractors prefer to go to court, a lengthy and expensive process for projects already financially in trouble. Others go bankrupt and cannot be collected from in any way. Expenses caused by construction problems, like those due to natural or human disasters, can push a marginal project into financial failure.

Characteristics of Tenants. In the project sample, the information on tenant composition was quite limited. No data was available on family size, age composition or income. Thus, our conclusions are based on the case studies and other supplementary information.

Fundamentally, we believe that the effects of tenant composition in subsidized multifamily housing is essentially no different than it is in any sort of housing for low income people. The eligible populations for subsidized housing are poor, which means not only that they have low or moderate incomes, but that they also have few resources to tide them over the hard times of unemployment or other crises that can interrupt their income. Their variability in income affects their ability to pay the rent regularly and on time. Many families are on public assistance, which smooths out the variation, but the amount is low and always needed for other basics of life. Rent does not always have the highest priority. The high incidence of large families means that subsidized projects, with the exception of those for the elderly, will have a higher than average density of children seeking outlets for their energy in constructive or destructive ways. Where these children are members of single-parent households, the task of adequate supervision may prove too much. In a general atmosphere of social breakdown, characterized by crime and drugs, people are disposed to act in short-range, selfish and socially destructive ways. For juveniles lacking the mobility that is characteristic of families of medium and high income, their world consists of the immediate area in which they live; it is that immediate environment, the project, that must absorb the impact of their presence and too often the high costs of wear and tear and vandalism that ensue.

It is difficult to deal with tenant characteristics separately from those describing projects' social performance. People's behavior is intimately bound up with the social environment in which they find themselves as well as their own personal values, life-cycle stage or resources. Insofar as projects are occupied by large families, often with single parents, there are bound to be heavy demands on apartments and surroundings. Poverty does not lessen these demands. On the contrary, to the degree that poor families are unable to provide other outlets or resources, their dependence on the social system is the greater. A striking characteristic of "good" low income housing both in the U.S. and elsewhere is the degree to which it exhibits a strong sense of community and social cohesion among its occupants.

There is no doubt that subsidized housing attracts its share and more of difficult tenants. By and large, in failing projects they are apathetic or downright hostile, with costly results. Yet, we observed cases in which vandalism and antisocial behavior were virtually absent, and that achievement was not necessarily gained by excluding risky tenants or employing large security forces. Unfortunately, the ability to generate a supportive social environment seems to be beyond our capacity in most instances. If tenants could realize more than just shelter in a subsidized project, the results might be very different. There has been much controversy over the issues of tenant participation. It presents a threat to management control and has led in some instances to acrimonious stalemate. Perhaps the wounds are too deep and the patterns of antisocial behavior by some part of the population are unbreakable. But the cost of housing that is not truly a concern on the part of its inhabitants will eventually be too high to bear, if it is not so already. Ultimately, the only way to a decent living environment for low income people seems to be the creation of a social situation that is mutually supportive rather than alienating and destructive.

Ownership and Financial Characteristics. The implications of the structure of incentives for performance are clearest among lending institutions and owners of subsidized multifamily housing. Too often, in the cases studied, owners and sponsors had only limited engagement with failing projects. Non-profit owners have essentially no equity interest in projects; though their commitment of seed money may have represented a financial sacrifice, it was seen as a contribution rather than an investment. Despite HUD's screening efforts, which were necessarily limited by the difficulty of finding appropriate indicators of capacity, sponsors appear to have taken on projects with little real understanding either of housing or of the resource and human demands that were likely to occur. In some cases, the people in charge, though committed, were inexperienced, backed by no organization and unable to learn fast enough; in other cases, the organization was large, but thinly spread and constantly changing personnel. HUD staff literally never dealt with the same person more than once or twice.

Limited dividend sponsors have a larger equity, but in comparison with conventional housing it is frankly negligible. Despite individual concern for housing, the main consideration is the tax shelter provided by depreciation. Since tax savings are threatened with recapture if foreclosure occurs before ten years of ownership are over, the general partners may be pressured to take an active interest in project operations. In some cases studied in detail, this happened less often than not. In others, general partners appear to have milked projects for cash. Since HUD has been reluctant to follow through on foreclosure, limited partners continue to enjoy tax shelters on failing projects whether rescue attempts are made or not. Even if a project is foreclosed, there is some question as to the vigilance with which IRS will seek to recapture excess tax savings. Finally, although the combination of sponsorship, development and construction in a single entity statistically reduces the chances of failure, it allows owners to recapture very quickly their investment through profits on land, (confirmed by HUD audit), design and architects' fees, and construction. When a project cannot meet its obligations, they bail out.

Mortgage institutions, protected from risk, have similar disincentives to active responsibility. Private mortgages have their investments insured by HUD and risk only lost interest and inconvenience. Commercial banks usually cease to be involved after final endorsement, when the mortgage is typically sold to FNMA. The vigilance of FNMA is not necessarily unceasing. While its inspections and reports are accurate, they seem also to come too late. Since FNMA has purchased mortgages at a discount, its incentive to hold onto mortgages when default occurs is defined only by the costs involved in foreclosure and social obligation. Altogether, the absence of substantial financial risks, originally an incentive for participation, leads to a situation in which financial principals have little to protect. They behave accordingly.

Ownership is also the source of other problems. Nonprofit sponsors do indeed tend to be inexperienced in the operation of housing. Despite their good intentions they are not necessarily in tune with their tenants. The consultants who assist sponsors during development have little or no counterparts during operation. In addition, consultants are not always effective or honest. However, when other variables, especially their target areas and populations, are taken into account, the degree to which nonprofit ownership is related to failure is lessened.

Limited dividend owners do not necessarily behave as though to protect their investments. Notably more effective were those combining identity of ownership and management. Some owners have been ineffectual or negligent in the selection of project managers; others appear to have simply made off with project funds. While often pointed to as possessing superior and "hard-nosed" management capabilities, limited dividend sponsors coming from a background in the conventional apartment market by no means understand or sympathize with the populations that they are expected to house in subsidized projects. Their conception of what is properly included in the housing package may not be appropriate to the needs and dynamics of that population. In fact, only among limited dividend owners was prior experience in the program related to success. The prospect that limited dividend owners will pull out wholesale once the minimum time for tax shelter recovery arrives is both real and potentially serious for those projects that are not clearly good investments.

Financial variables were extensively analyzed for the statistical sample. Factors such as the percentage of costs accounted for by land, administration, taxes and operating costs correlated negligibly or not at all with failure. Although a number of case studies confirmed the HUD Auditor's Office findings that land prices have been locally inflated with windfall gains to investors, no general pattern of excessive land shares in cost could be associated with failure. Excessive local real estate taxes and lack of HUD support in efforts to reduce them were also suggested as contributing to failure in some cases. Again, no general pattern could be found. The one financial variable somewhat associated with failure was the absence of any surplus of revenue over costs. This is, of course, another way of saying that such projects tended to have negative cash flows. The problem of cost estimation is discussed in conjunction with HUD processing below. Inflation is considered in the next major section of the report.

Management. Similar questions of responsibility and incentives may be asked about management of subsidized projects. Management entitites are closest to projects and might be most concerned for their welfare. Large firms care for their own reputations and fear being blacklisted by HUD. However, for smaller firms the sanction may not be very powerful. The practice of a fixed management fee and variable definitions of what is an allowable expense (for example, the on-site manager's salary) provide no positive incentive for effective management performance. Whether a project has high or low turnover, vandalism or crime makes no difference. However, in this instance, we need to ask a prior question. What does it mean to manage subsidized housing?

There seem to be two "successful" strategies of management for projects like those in the sample. One approach is to maintain the project's financial and physical condition by rigorous and essentially external control. Tenants are screened carefully for risk; those who fail to pay their rent are promptly evicted; disruptive behavior or nonadherence to project rules are similarly treated; tenants are charged for damage attributable to them or their children; recreation and amenities are limited -- often the recreation buildings are spotless but unused; and the project is aggressively patrolled by a security force that maintains close relationships with local police. The result is a quiet, well-maintained, if expensive project, in which the tenants' personal responsibility and involvement are not great, but also one which they are not attempting to leave.

An alternative style for management involves the conscious effort to create a sense of community in which activities for the different population groups are fostered; some degree of tenant organization occurs; negotiations with tenants precede eviction, which is nevertheless enforced if necessary; partial responsibility for activities such as maintenance are carried out by tenants; and, in short, every effort is made to set up an internalized system of social control.

To avoid being carried away by one or the other of these polar scenarios, we should note that both have in common the objective of social control of individual behavior that can threaten the financial, social and physical viability of a project. Both are possible, but both are difficult to establish and maintain effectively. Both are costly, the former in maintenance and security costs, the latter in social services and facilities. It is unlikely that managers skilled in one style can easily adapt to the other, and it is unlikely that either style would be satisfying to all types of tenants. Finally, the probability that either one or the other can be achieved in a pure form on a mass scale is slim.

In practice, most projects seem to fall between these poles of management. Good management firms and individual managers are very difficult to find -- and subsidized projects need very good managers. Budgets are insufficient to attract or support sufficient numbers of skilled maintenance workers and supervisors able to handle large projects. Onsite managers may be appointed without skills or experience. Faced with constant crises, managers give up or retreat into ineffectuality. Absentee management firms do little to improve the situation. In the statistical sample, the judgment that a project was well managed correlated negatively with failure quite strongly, but the meaning of "good management" was less clear. Few specific characteristics, such as professional management, resident managers, and experience correlated strongly with failure. By far the strongest negative relationships to failure was found for continuity -- a single management since occupancy. However, this may be more a consequence than a cause of success. Its converse, repeated management turnover, nevertheless would be a useful indicator that failure is likely to occur.

It has been common to blame the quality of management for the problems of projects such as these, and it is indeed true that management has been weak or negligent in many cases. Yet it is doubtful that good management alone can ensure the success of projects. Equally important is the provision of a setting in which reasonably good management can afford some mistake of judgment or performance without seeing projects fail, and in which consistently poor management is promptly identified and dealt with.

<u>HUD Programs and Processing</u>. Originally, HUD was not intended to participate in the management of projects. Long deeply involved in programs for housing construction and financing, HUD's potential role as owner of last resort was masked by the expectation that mortgage insurance would function in a way similar to that in the conventional private market. As a result, monitoring of projects has been insufficient to let anyone see danger signals, even though conventional market mortgagees are careful about such things. Estimates of operating expenses have been cursory and inaccurate, the commendable desire to get projects built within program constraints leading to the acceptance of unrealistic estimates and generally to discounting inflation. The same pressures led to exclusion of features such as recreational amenities that might be vital to project functioning. Project

management and operations have been left to managers and sponsors.

Among the case studies, not every project that was examined exhibited gross underestimates of operating and maintenance costs in its first year of operation, but the exceptions were rare. If budgets are set this tightly, then either they are unrealistic or the project managements must be routinely expected to be extraordinarily effective both in collecting rents and holding down costs. It appears that operating cost and revenue estimates have been technically faulty or forced to make projects feasible. Where the underestimation was done by developers, HUD did not challenge it. The resulting financial instability creates a situation where projects need rent increases as soon as they begin operation. No margin is left for mistakes or unexpected events, such as fires or earthquakes, that do happen. In order to fit rents within the program limits, amenities and service aspects of projects are slashed, while in some instances design elements that later proved to be the source of problems were left in. The statistical analysis confirms these conclusions with the caveat that the critical concern in predicting failure is not underestimation of costs or overestimation of revenues alone, but the quality of the net estimate.

The lack of clear responsibility previously discussed appears to be important in HUD's responsiveness to projects in trouble. Requests for rent increases need careful screening to protect tenant interests, but they should not take months or years to process. Similarly, the reluctance of HUD to foreclose, or even send projects into receivership, may be a valid effort to save them, but it also reduces the agency's credibility with owners and sponsors. To the extent that local HUD staff are uncertain about their role, have limited means of response to financial difficulty and the processing of those responses is slow, the aura of uncertainty about a project that is in trouble will be increased and the more likely it will be that other participants will try to back away.

The analytical and case-study findings are not definitive. We believe that this is no accident. Subsidized multifamily housing programs have developed and functioned in a larger structural context. To understand failure in a single project it is not enough to examine its special circumstances alone. Failure occurs as part of a larger pattern that needs to be examined and interpreted.

Subsidized Housing Failure: The Structural Context

Despite the protestations of practical men, every program that has any continuity and coherence is grounded in a theory about values and behavior. Government housing programs in the U.S. are no exception to this rule. They are, unremarkably, founded on the basic proposition that the private market, responding to individual initiative and local conditions, will supply to consumers who have the resources to pay for it housing that is better suited to their desires and cheaper than would be built by government or other non-market agencies. The proposition may be regarded as self-evident, nontestable, or wrong depending on one's point of view. In support of the former position is the clearly superior quality of housing enjoyed by a large proportion of the U.S. population in contrast with inhabitants of other countries where housing is publicly provided. However, resources and incomes in the U.S. are substantially greater than in most other countries, rendering comparison difficult. And some might argue that the private market does not actually behave in accordance with most theoretical descriptions of it; that consumer sovereignty is warped by advertising and monopolistic practices; and that the resulting allocations do not necessarily meet social needs.

For present purposes, it is not necessary for us to argue any of these positions. Rather, we need only to accept that the proposition, as a description of the strategic basis for housing policy in the U.S. is essentially correct. Even though it may be tempered in practice by desires to realize social objectives on the one hand or to support industrial and commercial interest groups on the other, policy has been articulated on this basis.

If the private market is seen as the optimal form for housing supply, then both the nature and form of strategies for government action in relation to housing are deeply preconditioned. This is evident even in such simple characteristics as the use of the term "intervention." The function of government in housing is to intervene in the working of the market in order to achieve social objectives that might not be attained in a pure, private market; but that intervention should occur in a way that takes advantage of individual enterprise and the profit motive and minimally distorts incentives for efficient production and competitive sensitivity to consumers' tastes. Both government's role and the appropriate strategies assume that the market can be efficiently induced to meet socially or politically defined objectives.

The history of the U.S. housing programs since 1945 both supports and challenges this basic tenet of policy. Certainly, the development of FHA mortgage insurance for single-family homes provided innovations in financing and a degree of protection and reduction of risk that must have speeded the great suburban building boom of the 1950s and 1960s. In the context of rising income and population, facilitating the provision of capital for residential construction was a feasible course. The style of government intervention, best expressed perhaps in the FHA ethos of the program as an insuring rather than a housing production activity, was entirely consistent with the prevailing beliefs both of consumers and of builders and lenders. FHA staff developed a professional style and high technical expertise that fitted the market in which they functioned. And if, as seems to be almost universally the case, the attitudes of producers and regulatory government agencies became increasingly supportive of each other, nevertheless the program did not develop internal crises of functioning or financial incapacity. A large proportion of American families was occupying new and high quality housing. The others were expected to follow in their footsteps.

But they did not. Far from disappearing, the poor and ill-housed became more evident, even as the central cities decayed. At least since the time of Lawrence Veiller and the New York tenement house reform movement in the late 19th century, housing specialists have debated the ability of the private sector to supply adequate quality housing to poor people at prices they can afford. Both the advocates of public housing and the supporters of government regulation have seen their hopes disappointed and their strategies negated by experience. Code enforcement often produced perverse results for the inhabitants of housing subjected to it. Faced with rising rents, they were often forced to move to cheaper quarters similar to or worse than those for which the programs were designed. In the ruins of Pruitt-Igoe, public housing, perhaps unjustly, was similarly discredited as a strategy. Yet the trickle down of the new waves of housing occurred very slowly. During the 1950s and 1960s aggregate housing indicators measured by the U.S. Census continued to improve, but standards also rose and a persistent and visible portion of the population remained ill-housed.

At least in part, this persistence has been attributed by critics to highway and urban renewal programs, the ultimate merging of builders, lenders and public officials who saw the needs and opportunities in rebuilding city cores but were insensitive to the existence of stable if not always visually tidy social communities. Many good neighborhoods were destroyed in the process of renewal and road building. But a systemic explanation, the sheer volume of suburban residential investment, its attraction and promotion to consumers as a desirable lifestyle, and the mass migration of middle and moderate income families to the suburbs is more convincing. The cities were being emptied out, partly as a result of public policy, partly as a reflection of the growth of affluence and the desire of people for a place of their own in a pleasant environment. The poor were economically and geographically left behind.

Both the visible decay and the rhetoric of the 1960s demanded a housing response. There were a number of conflicting alternatives -- among them suburban development of low-income multifamily rental housing to equalize opportunity and access to jobs and to counter racial discrimination; inner city rehabilitation and home ownership for poor and moderate income families; cooperatives and non-profit housing. To some degree, all were tried. But the central theory, that incentives to the private market would bring about the socially desired result, remained unchanged.

It is no part of this paper to describe or analyze the results in programs for single-family housing. The massive problems are well known, especially where "rehabilitated" inner city houses were involved. In multifamily housing, two organizational forms were developed, the limited dividend and the non-profit sponsor. Under mortgage guarantees, very large quantities of housing were rapidly built in the latter part of the 1960s and early 1970s. Very rapidly, too, they began to default and fail, ultimately returning to HUD ownership.

What was the theory? In many respects, it was highly sophisticated. Taking account of earlier denunciations of public housing, these projects were generally moderate in size and height, located both in suburban areas and inner cities, and visually indistinguishable from conventionally financed and constructed apartments. The program was designed to attract efficient non-marginal private developers, taking account of the fact known to every real estate specialist, that investment in real property in the U.S. depends upon tax structure for its profitability. Non-profit organizations that wanted to sponsor housing also could participate and special provisions for financing and technical assistance were made for them. In addition to the insurance and interest subsidies, rent supplements were available to projects serving large populations of low income tenants. Large numbers of projects were processed by HUD with unprecedented speed.

Under comparable circumstances in the 1950s, FHA, in conjunction with private investment became the instrument that reshaped the national urban system. But that was done with conventional market standards of risk, profitability and client selection. Failures were modest, never sufficient to threaten the program. In contrast, by early 1973, in the face of rising failures, a moratorium was placed on the entire subsidized housing program and production slowed to a trickle. Clearly, something about the theory was deficient, but was it the basic assumptions or the execution?

The question is not answerable absolutely. In fact, the program did generate a very large volume of subsidized housing very quickly. Both profit and non-profit organizations were eager to participate. Institutional financing became available for low and moderate income housing. But there is a vital difference between this program and other forms of intervention. The involvement of government was not simply to guarantee loans and reduce the risk for lending institutions, thereby encouraging them to make loans on a large scale to people whose ability to pay was scarcely in doubt. In addition to that facilitating role, government was committed to subsidizing and remaining the residual risk taker for families whose income was by no means secure and, indeed, whose eligibility for residence in the housing depended on their not exceeding a maximum allowable income. This is a risky proposition requiring very careful attention to a project's condition. Under normal circumstances, the lender, facing the risk, would give that attention.

<u>The Problem of Incentives</u>. At the core of a theory of government intervention to make housing profitable as an investment are two assumptions. The first is that sufficient incentives will attract lenders and builders to participate in the hopes of realizing profits from the process of construction while performing efficiently. This is the basis of a bidding process in virtually all public works. The second is that the resulting housing will be so financially attractive that lenders will view it as a good investment and maintain their involvement over time. In this circumstance, mortgage

insurance becomes a way to smooth participation by removing the risks attendant upon rare failures. Like all insurance, it is not designed to deal with situations in which lenders want to opt out in large numbers. As insurance, it is only feasible so long as the risk of failure is such that the program is actuorially sound.

Builders and lenders in the U.S. are familiar with construction of publicly subsidized projects. The construction industry demands a continuing level of investment in order to maintain its activity and employment. Contracts and development are familiar ways of making money. On the public side, efforts to monitor quality and profits continue in the never-ending tension and symbiosis between government and the private sector.

Going beyond construction or supply of products raises entirely new sets of issues. Acceptance of responsibility for provision of a subsidized service to populations who would otherwise be unable to consume it involves both risk and the potential for profit and abuse. More importantly, if participation requires incentives that virtually eliminate risk, why should participants view their involvement responsibly? If the argument for private efficiency says that investors will watch carefully over projects in which they stand to lose a great deal, why should they divert their energies from other really risky projects on which they are involved to those in which they face only limited possible loss? Perhaps the fear of losing future business in the insured activity might be enough. Yet that seems unlikely, especially when the programs have been suspended. There seems to be a paradox in which the price for participation is the removal of risk; but risk is the spur that is supposed to ensure watchful supervision of the investment. The incentive to participate reduces the incentive to perform. Exactly why good performance will take place is never made clear. Certainly it is not altruism.

A first structural flaw, through intervention by carrots and sticks is that the incentives appear to be self-defeating. Nothing in it ensures or even promotes real long-term concern for the welfare of the investment by the lender. Furthermore, under certain conditions, for example inflation and sharply rising interest rates, the incentives are actually reversed. It becomes more profitable to a lender for the project to fail if the mortgage commitment can be moved elsewhere at rates of return that are sufficiently attractive to offset the costs involved. Throughout the case studies, there was a pervasive sense that no one was really responsible for projects, that the buck stopped nowhere. In fact, it does stop at the FHA Commissioner, but usually too late.

We may ask whether the incentives to other participants are more rational and conducive to effective long-term survival of projects. Perhaps the most enmeshed are participants in limited dividend projects. For most of these, the principal value of participation resides in the tax benefits accruing from the project. Over time, as depreciation declines, the value of participation is reduced. However, the investor cannot pull out until the statutory period for recapture of tax gains has passed. During that time, an investor has a strong incentive for the project to remain solvent, even to the extent of advancing further resources to tide it over difficulties. But once the recapture period has passed, it is quite unlikely that participation will be economically profitable. We may anticipate that investors will seek to sell projects and certainly will not save them from failure by further cash advances. Since the value of many projects will be questionable by that point, more failures are probable. The question of the length of the tax recapture period and how vigorously IRS pursues recapture seems to be open to question. A careful study of its implications for HUD is warranted.

The Problem of Inflation. A second, very striking structural characteristic of the programs concerns the financial margin that a project is likely to have and the incentives of participants to maintain and increase it. Every rental housing project is a compromise between the cost of owning and managing the property and the rents that it can command. The difference, together with tax advantages and possible capital gains, constitutes return on investment. While it is no secret that many conventional housing projects have paper losses for tax purposes, most of that loss is normally accounted for by allowances for depreciation. A negative cash flow is regarded, quite properly, as a very serious problem.

To avoid a negative cash flow, a project must be able to cover mortgage principal and interest payments, taxes, utilities, management, maintenance and replacement from its current rental income. For this to be achievable in a new project requires a correct judgment of the rent that can be commanded for the chosen quality of housing at that location, together with accurate and uninflated costs for construction and operation.

A conventional project normally is developed with a reasonable degree of expertise and assurance on these factors. The risk to the lender and investors is well recognized and assessed. If the decision proves to be based on inaccurate predictions, the choices of liquidating the project at a loss or putting up more cash to protect a good investment are possible because the investors typically have access to some other financial resources. Where they do not and become over-extended, they fail. All along, there are strong incentives for financial backers to estimate costs and revenues accurately, control construction and take care of the project.

How does a subsidized project under this form of intervention compare with this model? In theory, it should differ in several respects, few of which would tend to increase its relative stability. First, virtually by definition the project is one that private lenders and builders would not otherwise undertake.* Looking at the prospective incomes of tenants, location, building codes and standards, they see no financial incentive to build unsubsidized low income housing. People simply cannot afford to pay what it costs. The tenants themselves are not only likely to have low or moderate incomes, but their incomes will fluctuate and they have few resources to tide themselves over periods of unemployment. During inflation, their incomes are likely to rise more slowly than the general wage and price level. They are furthermore likely to have substantial numbers of children and, perhaps unfairly, are often associated with problems of crime and social deviance in the minds of investors. They are more likely to be ethnic minorities with all the attendant overtones.

The subsidy and incentives must overcome the financial and emotional obstacles that would normally cause investors to stay out of the market. They may succeed in attracting developers, but the process will not be identifical to that in a conventional development. For example, where in a conventional project the risks and returns in construction as against ownership may be comparable, for subsidized projects the greater long-term risks make construction a much more attractive proposition. Any means to shorten the payback period are likely to be employed. At the same time,

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* If the incentives are especially attractive, developers will try to take advantage of them with projects that they may have judged feasible under conventional financing. How many such projects exist is a virtually unanswerable question.

the limitations on rents mean that the costs of land and construction will be delicately balanced against operating costs. As many observers have pointed out, there is a strong incentive for developers to seek short-term returns by inflating land and construction costs while underestimating operating expenses to the degree necessary to remain within the allowable rents. Under conventional circumstances, these figures would be analyzed with great care by lenders. In the subsidized project, they are the responsibility of HUD staff, who may be competent but do not bear the risks. In fact, at the early stages of the program, they were left to HUD staff primarily responsible for construction and standards. Operating expenses were nobody's chief concern until the project was built and moved into HUD management supervision.

But the cost dilemma of subsidized projects transcends the initial tension between construction and operation. It is fundamental to conventional housing that rents can increase to match increases in costs of operations and maintenance so long as the market will support them. However, subsidized projects are designed to serve moderate and low income populations. Not only do their incomes tend to lag during times of inflation, but even if they increase, the statutory income and rent limitations on the project may not allow owners to raise rents. There are, after all, always more potential tenants at the original income level. This type of housing, then, faces a basic problem during inflationary periods. Should the rents escalate with costs, requiring the redefinition of allowable incomes and rents and exclusion of poorer tenants; or should the rent levels remain constant, leading to an inevitable financial crisis? The former solution means that the housing no longer serves its target population. The latter means that the financial and physical viability of the housing itself is threatened. The dilemma of whether to serve the intended population or protect the public investment is a harsh one. It is also universal. To the degree that projects serve who they are supposed to, they will eventually face the cost-revenue squeeze.

Attempting to meet both objectives, HUD's response has been ambivalent. Rents and income limits have been raised but with great reluctance. Whatever subsidies and mortgage debt work-out arrangements can be found have been used in individual cases, but public officials are understandably reluctant to create precedents for financial support for which the potential demand is enormous and the anticipated resources limited. And rent supplements or potential relief from Section 8 leasing are limited although they do help. This strategy amounts to an attempt to pass a good part of the cost increases on to the owners and managers of projects. They may be better able to afford the burden than tenants, but, as a strategy, this can be only a very short-term solution. In the conflict between owners and rent regulators, owners have always found ways to force tenants to absorb costs by reducing the quality of housing supplied. In the absence of tight regulation, the first means of so doing is to reduce maintenance, the one postponable cost item.

But, as the crisis of public housing in the 1960s demonstrated, reducing maintenance in housing for poor people is a dangerous strategy. Such projects are subject to great social pressures and their inhabitants up to now have had neither the resources or social organization to do for themselves what management will no longer do. The resulting dynamic process was seen most clearly in public housing, but it has also widely occurred in private housing. The projects typically house numbers of children who create wear and tear; they are also the object of theft and sheer vandalism. If maintenance is not continuous and responsive, physical deterioration may rapidly become so great as to be essentially irreversible. Tenants who are financially better off will then start to leave, resulting in revenue losses from vacancy. Vacant apartments are themselves vandalized before they can be let, leading to further cumulative deterioration, loss of rentals and repair costs. The process eventually destroys the project physically, socially and financially. There has been much debate on the causes of the phenomenon. In public housing, especially, design has been heavily criticized. Yet maintenance appears at least equally important. Poorly designed units have remained habitable, if not very desirable, with sufficient and continuous maintenance even in most adverse environments.

There is no long term way around this predicament of subsidized housing. Adequate housing cannot be built from scratch at a cost within the ability to pay of the lower income population. If we build new, then we must subsidize. If a subsidy, such as interest rate reduction, has a form that makes no provision for rising costs, then the projects will inevitably fail. To expect otherwise is to bet against inflation -- a risky proposition. In a particular instance a multitude of causes may be adduced, but the brutal fact is that this type of program creates a propensity to failure for all projects, not just those that are more obviously corrupt or mismanaged. Any factors that can generate a financial problem can precipitate failure.

Remedies. What resources are there to counter potential threats to project viability in a sufficient and timely way before failure ensues? Rent increases are a limited device, eventually pricing the apartments out of the reach of the program's target populations and commonly slow in being approved. When a project defaults on its mortgage, the only means now used to correct the default are rent increases and mortgage modifications, including the waiver of principal payments and payments to the reserve for replacements. The statistical analysis demonstrates that these methods are very limited, often merely delaying failure for a short while. In some circumstances, owners may make further equity contributions in the form of loans. They are reluctant to do so. The additional device of the operating loss loan from HUD is not widespread, though likely to be popular. If timely, such remedies can help but not solve the problem; in practice, they are often too late or too meager to do more than postpone the inevitable collapse. Meanwhile, projects continue to deteriorate and the quality of management and maintenance declines. Ultimately, projects can be placed in receivership or foreclosed and handed over to specialists, again with no guarantee of rejuvenation. In the limbo status that precedes this conclusive act, a project can drag on without concerted and vigorous intervention. The available remedies may not worsen the condition of failing projects, but they are hardly a match for the complexity of housing failure. In the following section, we discuss some potential additions and alternatives.

II. RECOMMENDATIONS

When a program is experiencing deep problems, due in part to its structural circumstances, it may need major changes. We will suggest that overall policy be reexamined. However, we also recognize the constraints under which programs are managed in reality and the necessity to respond to problems at whatever levels can be attained. Therefore, the following recommendations include immediate short-range and limited scale proposals that appear to be implementable with a reasonable expectation of success. Policy proposals can be advanced only tentatively on the basis of a limited study such as this one. They need very careful examination and debate before adoption. Operational proposals, on the other hand, can be put into effect at limited cost and effort, and may still yield some benefit, even if it is only to delay the failure process while more substantial remedies can be sought. The recommendations, then, are divided into two groups: (1) recommendations for broad policy; and (2) recommendations for specific program actions. Within those groups, we will further distinguish between proposals for responding to the plight of existing housing sliding into failure and proposals for new housing programs in the future that will inevitably face the same pressures.

Broad Policy Recommendations

The basic fact seems to be that the current form of organization and financing for development and operation of subsidized multifamily housing is inherently likely to generate failure under inflationary conditions. The incentives to participate do not encourage protective and responsible behavior toward investments; the types and levels of subsidy provide no long-term assurance that costs can be covered from resources; HUD's role as guarantor of mortgages provides neither a means for effectively intervening in management of failing projects nor any suitable responsibility for dealing with them after they have failed.

Maintaining the viability of the present stock and ensuring that construction under new programs does not have the same results will take perhaps more than can be reasonably expected of any government program. Nevertheless, the existing system does not work.

(1) Provision of New Subsidized Housing: The role of HUD as a guarantor of mortgages for construction of low and moderate income housing is self-defeating. Even though short-run palliative changes may be made, it is now time to look for alternatives. What are they? On one end of the scale are housing allowances and other forms of direct subsidy to tenants. While theoretically powerful, they are likely to be very costly (as indeed is any real program to provide adequate housing to all who need it), and do not contain mechanisms to ensure that supply will respond to demand rather than exact monopoly rent. On the other extreme is public housing, also costly and seen as bureaucratic and politically unattractive. Between are a huge range of possibilities, for example, the creation of quasi-public national, regional or state housing development corporations with powers to finance and build housing for eventual ownership by nonprofit groups and cooperatives. Such new institutions would need stable capitalization and subsidies -- The New York State Urban Development Corporation has shown the problems that may occur if low and moderate income housing are otherwise financed -- but would not pass back large proportions of the subsidy to the private sector for no return other than participation.

Basic principles for reconstructing policy in this area might include many different perspectives. Nevertheless, the mechanisms for delivery of subsidies should do the following:

- Subsidies should focus on the point of need with minimum diversion for producer incentives.
- There should be clear and unambiguous responsibility and accountability for housing development and operation at each stage of the process.
- Activities should be carried on at an appropriate scale for affective and economical achievement of objectives.
- No part of the development process should be able to secure advantages to the detriment of effective operation at later stages. The test should always be viability in operation, not in construction or financing.
- Incentives should enhance the attractiveness of residential housing as a continuing investment rather than just as a tax shelter, which

implies concern for adequate cash flow and long-term maintenance. Where private sector participation supports these principles, it should be encouraged. Otherwise, alternative organizations should be developed. The task will not be easy.

(2) Policy on Existing Subsidized Housing: Looking at housing policy in this way highlights the ambiguities in HUD's position. The agency now is neither in nor out of the housing ownership and management function. HUD owns much housing but has neither the organization nor the mandate to look after it properly. Yet, it cannot divest itself of the housing either. And if it could, more would follow.

Both HUD and the national policy making system will have to come to terms eventually with the problems of failure and foreclosure. While tinkering with mortgage financing mechanisms may stave off the problem for a short time, failures will continue to occur and no such mechanisms can deal with the long run problem of rising costs.

It is therefore necessary to reconsider policy on treatment and disposition of failing subsidized housing. The principles for action are similar to those above. The central objectives are to preserve the housing at a decent level of quality while ensuring that it continues to serve its target population. The options range from sale in the open market, with no strings attached, to direct operation and management by HUD itself. Between these are such possibilities as transfer to local housing authorities or community corporations, or public or non-profit ownership and management corporations organized and funded for this specific purpose. Such corporations would be publicly controlled, large enough to obtain scale economies and attract skilled technical staff, but not so large as to be out of touch with regional and local conditions. Against possible new alternatives, there should be arrayed the variety of financial devices, such as loan restructuring and operating subsidies that might be granted existing forms of housing entity.

The scope of this study does not include a full analysis of the alternatives that might be considered, whether or not they would require new legislation, and judgments as to which might prove more effective. HUD must find short range responses to the immediate problems of dealing with the failing housing that it now has. Nevertheless, we doubt that an effective policy can emerge from short-run palliatives. A thorough reconsideration of the foundations of HUD's strategy is necessary.

Specific Recommendations

Five types of specific actions could be taken within the present framework to improve HUD's control and ameliorate the problems of failure to some degree. They are directed toward: (1) HUD project information and monitoring; (2) Program management and support for not-yet-failing projects; (3) Responses for projects in failure; (4) New project development; (5) Research and experiments toward improved housing operation. Each group will be discussed below. They are not mutually exclusive, but rather supportive of each other.

(1) Project Information and Monitoring: Although local HUD staff have often learned quickly from the hard experience of attempting to keep track of and sustain projects sliding into failure, there are still major deficiencies in the management information available to them.

(1.1) Monthly Operating Statements: It is essential that HUD, as the ultimate guarantor of a project, be aware of its financial status and especially of the onset of symptoms of operations and financial difficulty. To a significant degree, this will be achieved with the implementation of systems such as the Multifamily Early Warning System (MEWS) that will provide operating data on costs and revenues on a monthly basis, or the Region IX, Sacramento Insuring Office Computerized Financial Analysis System. The current MEWS proposal concentrates, quite properly, on vacancies and cost-revenue relationship. Reports should be as simple as possible in the quantity and format of data to be reported by projects. However, we believe that effective flagging of potentially troubled projects would be improved by requiring also some indicator of the level of vandalism and notification of exceptional events such as changes of on-site or off-site managers, significant changes in numbers of staff, major fires or sharp outbreaks of crime.

(1.2) Annual Estimated Budget: While MEWS can improve day-to-day monitoring of projects for purposes of control, it does not provide for a broader intermittent review of a project's status and performance. The annual audited financial statement is currently a basis for such review, but it should be accompanied by an estimated operating budget for the coming year. This statement should be reviewed by HUD staff with the project management and subsequently used as a check for the data revealed in monthly operating statements.

(2) Program and Project Management and Support: The quality of program management and support by HUD staff varies. At best, it is well informed and sensitive to project performance; at worst, it is mechanical and focused upon formal requirements rather than how projects are actually doing. Everywhere, the lack of effective preventive measures and remedies is keenly felt. To improve performance without additional real resources for projects will be very difficult. On the other hand, new subsidies will be much more effective if combined with efforts by HUD to ensure that its staff have the means to assist projects in evaluating management and motivating good performance.

(2.1) Staff Development and Role: The broad issue of HUD's role in managing subsidized housing has its concrete counterpart in the uncertainty and variability in the perception of their roles by staff. It is hardly fair to ask that the latter be clarified if the former is not. Although in theory HUD is an insuror, in practice it is a deeply concerned investor on behalf of the public and its staff should behave accordingly. This means being constantly aware of what is happening in the projects through the information system discussed in (1.1) above, and actively intervening when necessary. In the absence of major changes, the only way this can happen is through the management agents of the ownership entities and through control of some significant means to alleviate projects' problems and motivate good performance. HUD Area and Insuring Office staff need to be appraised of their roles more explicitly to insure a reasonably uniform approach to project management. They also need training to improve their skills in analyzing performance and in developing special assistance. For example, at least one person in each local office should be able to advise and assist sponsors in questions of local real estate tax assessment and in applying for tax abatement or reassessment. A Regional guide or handbook for this purpose would also be helpful.

(2.2) Controlling the Quality of Project Management: Two measures might be considered to improve the quality of management in projects.

First, a management rating system should be established. HUD Area Offices should periodically rate the performance of management agents, using physical, financial and social criteria. The ratings could be compiled at the Regional level and circulated to all offices to aid in the selection or replacement of management agents. Negatively rated agents should be employable only under extraordinary conditions. The ratings should be supplemented with descriptive information on the organizational structure and general policies of the agents, including such characteristics as their scale, area of operations, and use of on-site personnel.

Besides identifying the better management entities, HUD offices would be in a stronger position if they were able to motivate performance with a sliding scale management fee. If, instead of a flat 7 percent of gross income, a range from 6 to 9 percent could be granted, depending upon performance, there would be a clear though limited incentive. The criteria for quality would need to be spelled out very carefully so as to ensure that program goals were not being distorted. The penalty for poor management would still be replacement.

(2.3) Financial Assistance: The question of operating subsidies is really beyond the level of these specific recommendations. Nevertheless, they appear to be ultimately necessary in one form or another. Two issues will need to be faced if subsidies are in fact instituted. First, how will HUD insure that the subsidy is actually used for the designated purpose and not simply as a way of draining cash from projects? Careful monitoring of expenditure levels with selective detailed audits will be necessary. Second, for limited dividend projects, what should be the relationship of the subsidy to the equity of the partners? One possible modification would be a requirement of additional cash contributions by partners as a condition for the subsidy.

(2.4) Responsibility: Although we believe that HUD has no short-run alternative to increasing its level of project control through monitoring and management, every effort should be made to involve other participants on a continuing basis. If an estimated operating budget is required, it could be made on the basis of an annual project review (preferably including an on-site inspection) at which representatives of the sponsor, tenants, management agents, mortgagees and FNMA are present. A medium sized project is a substantial enterprise and worthy of a face-to-face discussion once a year, before a crisis occurs, by those who are most involved. Obviously, such a process does not offset structural problems, but it does perhaps force their mutual recognition. And it can assist in the recognition of problems before they have reached the stage of irreversibility. Experimental use of such a review process is suggested to begin with.

(2.5) Tenant Participation: The issue of management style is deferred to section (5) below. However, there is evidence that long-term project viability will require more active and effective levels of tenant participation than is now the case. This will be especially true if operating subsidies are not forthcoming and costs must be held down. Voluntary participation in maintenance will then become critical. Without a sense of community, it will not occur. HUD now has no policy on the formation of Tenant Advisory Councils in insured projects. It should seriously consider requiring that lease and grievance procedures similar to those of public housing should apply to all subsidized multifamily housing. We recognize the potential problems involved in such a policy, especially the fact that managements will consider it a threat. Participation can only work if there are clear agreements as to the kind of responsibility which is offered.

(2.6) Recreation and Social Services: HUD should actively encourage the provision of on-site recreational facilities and social services, for example, day care, and should direct some part of future funds for operating subsidies and rehabilitation toward these purposes. Toward this end, local offices should identify projects that have especially large populations of children and young people and assess the quality of their recreation by on-site inspection.

(3) Responding to Projects in Failure: It has already been noted that once a project has failed or is close to failure, the available remedies are of limited utility. The fundamental problem seems to be the general deterioration of projects that accompanies the process, making it necessary to generate new capital for repairs and rehabilitation as well as cash to cover operating losses. Both of these needs must be met to rescue a typical failing project. In addition, less tangible improvements in management, control and social performance are likely to be necessary. Putting everything together is not an easy task.

(3.1) Evaluation: No one can do anything useful about a failed project without understanding what is going on. HUD should develop at least one failure specialist in each Area Office whose function it is to understand and evaluate what is happening in failing projects. The failure specialist would work with HUD management staff and other participants to evaluate and if necessary gather information on projects being considered for further capitalization and subsidies. This function should develop a center of knowledge and operational skill in dealing with failures within every office. The specialists should be encouraged to meet and exchange information and thereby develop a regional network of mutually assisting staff with this concern. Project evaluation will require criteria for the critical decision as to whether a project should receive assistance or be otherwise disposed of. The possibility of private resale or demolition should not be excluded.

(3.2) Financial Support: Alternatives for providing capital and operating subsidies to failing projects are now under consideration at HUD's Central Office. Among the possible options are reduction of mortgages through foreclosure and resale, which is, in effect, a lump sum subsidy from HUD which has insured the original mortgage; operating subsidies; rent supplements; and varieties of forebearance on mortgage payments, the shortfall being either capitalized through an extension of the mortgage or by a balloon payment. Although some form of capital infusion is likely to be often necessary at least to make up for deferred maintenance, the provision of a one-time subsidy is unlikely to be sufficient. Striking at debt-service problems alone will not solve the operating cost dilemma. Unless costs cease to rise, the revenue-cost squeeze will inevitably reoccur. On the other hand, the control of operating subsidies to ensure that they are used for their intended purpose and serve their target populations is likely to be difficult. Their use should be conditional upon evaluation and, if necessary, major reorganization of project management.

(3.3) Management: Bringing a project back from failure requires skill and tenacity. If the project's physical fabric and social functioning have seriously deteriorated, entirely new management may be called for. Some specialist failure management firms have emerged. At best, they exhibit a straight-forward approach that sets out the mutual obligations and expectations of tenants and management. At worst, they exploit situations that are already close to intolerable. Although it makes sense for HUD to encourage the development of specialists in failure management, they should be carefully reviewed and evaluated, a list should be developed, and the use of firms receiving negative ratings should be prohibited. Unfortunately, management of failing projects is demanding and often unpleasant. It is hard to find good management entities who will take on the task. The one advantage is the opportunity to make a fresh start, establish new ground rules and develop new expectations. HUD should encourage managers with this perspective and the ability to implement it. Training and information exchanges for managers should be undertaken.

(3.4) Disposal: What should be done with projects that cannot otherwise be saved? In part, the answer depends on the issues of strategy raised early, because "saving" means defining HUD's role. If HUD is willing to relinquish control of program objectives, especially targetting to tenant populations, then rapid disposal by sale or transfer may be a preferred strategy in most instances. In the long run, the projects are likely to return to the public sector for support if they are economically unsound, but for the moment, at least, they would no longer be the Federal government's responsibility. Within this strategy, transfer to local authorities or community development corporations might be feasible if linked to the commitment of local revenue sharing money. If HUD's objective is to remain in a guarantor-advisory role and projects are subject to program standards, then the transfer process must include sufficient capital and operating resources to make them financially viable. For those that are not, because of severe physical deterioration and abandonment, there may be no option but sale to the highest bidder or demolition. If the land is to be reused for new subsidized housing, the latter should be seriously entertained. We have seen at least one project built around the ruins of an earlier effort that were programmed for rehabilitation but actually caused enormous problems of vandalism and subsequent financial failure of the new project itself.

(4) New Project Development: Although it is unlikely that the 236 program will be reinstituted, HUD's participation in the development of new multifamily housing will not cease. No matter what the organizational form, there are some important considerations that should be part of the process of review for such projects. They include control of construction quality, cost estimation, location and design.

(4.1) Construction Control: Control over the quality and speed of construction is critical to financial soundness. If a project is delayed or contains serious physical deficiencies, rent-up may be delayed and repair costs incurred that establish a financial crisis from the outset. Good control and adherence to schedules requires prompt action by HUD whenever its review or approval is necessary, together with competent construction management by sponsors. In practice, the most effective way to achieve control is through sponsor experience. For non-profit sponsors, HUD should follow a policy of encouraging the formation and growth of capable, large-volume organizations that can operate in consortium with local groups to ensure good management of the development process.

Prompt correction of construction defects is too important to be left to the judicial process. A contingency fund is necessary, whether in the form of a percentage of the mortgage for non-profit sponsors or an escrow fund from syndication proceeds in the case of limited dividends.

(4.2) <u>Cost and Revenue Estimation</u>: HUD's procedures for cost estimation have improved greatly since the early years of the programs. Still, some principals for estimation need to be re-emphasized. The initial review and approval of proposals should include representatives of both Underwriting and Management Branches. In that process, the operational viability of the project should be given equal weight with its construction and development financial feasibility. Projections of costs and revenues for the first five years should be required. HUD, itself, should develop estimates of typical costs of operation of multifamily housing for localities that are scaled for size and type of project. These cost levels should constitute a mandatory check for all sponsors' estimates, whether low or high. If the start of construction is seriously delayed, cost and revenue estimates should be updated by formula or opened for re-examination.

(4.3) <u>Location and Design</u>: The quality of a location for subsidized housing is a subtle thing that can perhaps only be revealed by a process that encourages review and comment. This suggests that approval be conditional on an open review of project impacts similar to the Environmental Impact Statement and local agency review now required of other large capital investments. Among the criteria should be the impact of projects on open space availability, school crowding, public transportation and other service functions. Such a process may be complicated, but the costs of not doing it are likely to be severe in the long-run, no matter whether the subsidy is given through interest or leasing.

Design is a difficult issue. We found no systematic relationship between design and financial failure, nor do we know of any way to control design effectively. Although opinions differ, we do find that recreational facilities and open space are very important to projects with juvenile populations, and recommend that standards for recreational facilities be upgraded. However, it is also true that their utilization depends on the availability of supporting programs and the maintenance of a positive social environment. Evaluation of services and recreational facilities should be carried out for specific population groups in the project -- e.g., infants, small children, juveniles, young adults, the aged. Facility design should be checked for conflict and potential mutual support between these groups, and should be sensitive to its impact on the development of community.

(5) Research and Experimentation: Even after years of operation and conflict, what is not known about subsidized housing programs remains striking. Besides monitoring and evaluating innovations as they are put into practice, HUD needs to find out answers to questions critical to the future of its involvement with these programs and their successors.

(5.1) Management Style: There is no one successful management style, despite the implicit assumption to the contrary in many regulations and procedures. The problems in public housing, as well as in the projects examined in this study, make it clear that managing housing for low income families requires more than conventional market attitudes and skills to be successful. Furthermore, there is little agreement on what does constitute success. HUD should re-examine carefully the problem of management, starting from scratch, asking what is important, and looking at successfully managed projects in order to find out why they work. On the basis of this research, some projects should be selected for selective innovation in order to discover means of implementation. In an atmosphere of crisis and political demands, attention naturally focuses on failure and new programs. But there are also some remarkable successes. Their lessons should not be lost.

(5.2) Vandalism and Recreation: The problem of vandalism is universal. It increases costs and destroys the physical and social attractiveness of projects. Yet there has been little systematic study of its origins or of ways in which it can be reduced without massive costs in security forces. Like the management question, we suspect that this issue ultimately requires a clear perception of the type of social system that projects should have. Nevertheless, it can be attacked at a less general level and should be begun.

(5.3) Tax Shelters: The recapture rule on sheltered income provides an incentive for many limited dividend investors to stay with projects even when it means putting up more cash in order to do so. As the end of the period approaches and the falling depreciation similarly makes the investment less attractive, many will pull out. Under conventional market circumstances, projects would be sold off and new investors would gain depreciation benefits. But if the projects are virtually unsaleable owing to their financial condition, this may not happen. The result is a potential landslide of failing projects. We have not been able to investigate this question in any depth, but we believe that HUD should be planning now to estimate its implications for financial failure in coming years among projects that have so far been least likely to need assistance.

(5.4) Regional Differences: The persistent evidence of substantial regional differences in mortgage failure in both conventional single family and subsidized multifamily housing suggests that HUD should consider ways in which regional differences should be expressed in policy and operations. In part, this is already allowed by the existence of considerable Regional Office discretion. However, it is by no means clear that the areas of discretion coincide with those factors that vary regionally. This subject needs to be analyzed in more depth.