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office of audit **report**

Issue Date:
January 29, 1972
Audit Case Number:
05-02-2001-5000

TO: George Romney, Secretary

FROM: Elmer W. Muhonen, Director, Office of Audit

SUBJECT: Report on Audit - Section 236 Multifamily Housing Program

INTRODUCTION

The Office of Audit has completed a nationwide review of the Section 236 multifamily housing program. Our examination was made on a selective test basis and included a review of underwriting procedures, tenant eligibility and mortgage servicing, and the quality of completed construction. We visited 21 Area/Insuring Offices(field offices), and reviewed and analyzed 62 projects originated under the program. The projects selected for review contained about 9,450 units and represented about 25 percent of the total number of units ready for occupancy at June 30, 1971, in projects which were initially proposed under the Section 236 program.

In addition to reviewing and evaluating the processing systems and practices at 21 field offices, we visited and inspected 62 Section 236 projects and 124 conventionally financed projects. Twelve Section 236 projects and 24 conventionally financed comparable projects in the Hartford, Atlanta, Dallas, and Seattle Office areas were inspected by two-member teams

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consisting of an auditor and a HUD architect or design representative. The purpose of the inspections was to evaluate the project site location and the quality of Section 236 project construction as compared to conventionally financed project construction. Individual audit reports are in process of issuance to each of the 21 field offices in which our examinations were conducted relating to underwriting practices.

We also reviewed the Section 236 mortgagors' files and records to determine whether HUD's tenant eligibility criteria were being adhered to. Sixty-two audit reports on mortgagor practices and mortgage servicing activities have been issued or are in process of issuance to the field offices covering these matters. Exhibit 1 lists representative findings relating to tenant eligibility included in the 62 reports. Each field office will be requested to reply to the reports indicating the actions that have been or will be taken on our findings.

We requested and received written comments on the draft report from the Assistant Secretaries for Housing Production and Mortgage Credit and Housing Management. Their comments have been considered in preparing the final report.

References are included in the report showing the current designation of certain offices as Area Offices; however, most of the actions discussed in this report occurred when they were Insuring Offices.

SUMMARY

Generally our review disclosed that prescribed underwriting procedures were followed (although underlying data often was inadequate) and that for the most part eligible tenants were provided housing of good quality. However, we found a need to (1) establish additional policy guidelines, (2) reconsider a number of HUD policy determinations, and (3) improve certain operating practices.

Our audit results have been grouped into nine overall findings which, we believe, present significant opportunities for improvement in the administration of the Section 236 program.

HUD policies stemming from legislative requirements and ineffective project application processing practices have contributed to increased insured mortgage amounts. Because of the higher mortgage amounts, the market rents for Section 236 projects were generally higher than for comparable conventional projects. Additionally, HUD's interest assistance liability has been significantly increased.

Inadequate cost certification reviews on 21 of the 52 finally endorsed projects examined resulted in the inclusion of about $344,000 of ineligible and $281,000 of questionable costs in insured mortgages totalling about $111 million.

Outdated and incomplete data banks did not provide sufficient bases for estimation of construction periods, construction costs and allowances of incentive payments; and contributed to liberal land valuation practices.

Inducements to participate in the Section 236 program are directed towards achieving project construction; there is a need to restructure the inducements to encourage long-term ownership and efficient management.

On 4 of 62 projects reviewed, Section 236 program funds rather than College Housing program funds have been allocated to insure projects constructed primarily for housing college students.

Eligibility criteria for admission of tenants to Section 236 projects need upgrading through the establishment of minimum income limits to preclude hardships on tenants and to make the projects more viable. Improvements are needed also in the verification of tenants' income.

The criteria governing financial requirements for nonprofit mortgagor projects needs strengthening by requiring the provision of working capital and the establishment of a required amount of minimum mortgagor assets.

Numerous projects were situated on sites that, in our opinion, were undesirable for multifamily housing because of their remote locations, surrounding neighborhoods, and topographical conditions. Effective implementation of the proposed new project selection criteria can serve to eliminate such problems on new project applications.

Existing policy pertaining to cancellations of insured commitments needs modification to preclude insuring projects that may be jeopardized by local conditions affecting marketability.

Our findings on these matters together with related recommendations to improve the administration of the Section 236 program are presented beginning on page 7.

BACKGROUND

The Housing and Urban Development Act of 1968 established the Rental Housing Assistance Program (Section 236) to increase the volume of modern decent housing available to lower income families by authorizing interest reduction payments by the Federal Government which in effect reduce the rental charge to the tenant. These periodic payments, made to the mortgagee on behalf of the tenant, reduce interest costs on a HUD insured project to one percent, thereby reducing the amount of rent it is necessary to charge the tenant to cover the monthly cost of the project. These payments consider the mortgage principal, interest, and mortgage insurance premium fees. Only new or substantially rehabilitated structures are eligible under this program. The tenants are required to pay either the basic monthly rental or 25 percent of their income, whichever is greater; but not in excess of fair market rent.

As defined in the statute "market rent" for the Section 236 program refers to the rental rate necessary to cover vacancy and collection loss, and to pay operating expenses and principal, interest and mortgage insurance premium requirements on a level annuity mortgage at the market interest rate. Any rents collected in excess of the basic charge are to be returned to the Secretary and placed in a revolving fund to make other interest reduction payments. The project owner of a Section 236 project must be a nonprofit or limited dividend organization or a cooperative association.

Processing of a Section 236 project begins with an informal discussion of project feasibility between the sponsor and representatives of HUD. Subsequently, a request for feasibility analysis is submitted by the sponsor.

A feasibility conference is held to discuss the construction budget limitations set by HUD. When agreement is reached on the budget, a feasibility letter is issued provided reservation funds are available. The feasibility letter includes submission target dates, rent structure, cost limitations, mortgage land value and cash requirements. An application for conditional commitment is made by the mortgagee and, following a conference, HUD issues a conditional commitment. When final contract drawings and documents are complete, the mortgagee submits them along with an application for firm commitment. HUD then endorses the original credit instrument (referred to as initial closing); and, after a preconstruction conference is held, construction begins.

At September 30, 1971, there were about 3,800 Section 236 projects in various stages of development which either had been insured or on which commitments to insure were issued, with actual or potential insured mortgages totalling about $6.6 billion.

FINDINGS AND RECOMMENDATIONS

FINDING NO. 1 - POTENTIALS AVAILABLE TO REDUCE INTEREST ASSISTANCE

The market rents for Section 236 projects were generally higher than for comparable conventional projects, because of certain allowances permitted by law or regulation and ineffective administrative and operating practices. As a result, HUD's interest assistance liability has been significantly increased.

Our review of selected Section 236 projects and comparable conventional projects showed that adjusted rents for the conventional units were less than Section 236 rents for units of like size, as follows:

Unit Size	Percentage of Conventional Projects with Lower Rents
1 - Bedroom	93
2 - Bedroom	84
3 - Bedroom	59

Rents were compared after adjustments were made for utilities, extra amenities, and size disparity. In terms of economic value, the tenants in the selected Section 236 projects were receiving less value than tenants in the selected conventional projects.

Conventional projects were selected for comparison based on similarity of market area and unit composition. Comparisons were made after established market rents on non-HUD projects were adjusted by applying estimated plus or minus values for comparative size, utilities furnished, and amenities. For example, adjustments were made relative to the estimated value of utilities furnished without additional cost in Section 236 projects where such utilities were not furnished by comparable conventional projects.

Further adjustments were made for the estimated value of amenities such as swimming pools, air conditioning, dishwashers, garbage disposals, self-defrost refrigerators, extra bedrooms, community or recreation rooms, patios and balconies, drapes, and carpeting.

The following summary showing the differences between the Section 236 market rents and comparable conventional rentals as adjusted for the several size units in the areas we visited, indicates the generally greater value received by conventional project tenants:

AVERAGE MONTHLY RENT DIFFERENTIALS BY DWELLING UNIT SIZE
Section 236 Higher (Lower) Than Conventional

Field Office	1-Bedroom	2-Bedroom	3-Bedroom
Hartford, Conn.	$ 8	$54	$ *
Camden, N.J.	*	23	None[1/]
Washington, D. C.	30	21	34
Richmond, Va.	(3)	5	12
Pittsburgh, Pa.	42	22	*
Atlanta, Ga.	2	2	(18)
Tampa, Fla.	11	(1)	None[1/]
DesMoines, Iowa	20	4	(16)
Grand Rapids, Mich.	16	27	15
Indianapolis, Indiana	29	24	21
San Antonio, Texas	29	24	2
Dallas, Texas	19	20	(15)
Topeka, Kan.	16	15	1
Oklahoma City, Okla.	15	24	20
Portland, Oregon	12	3	*
Seattle, Wash.	64	43	23
San Francisco, Cal.	7	2	*
Sacramento, Cal.	5	19	(33)
San Diego, Cal.	11	27	*
Denver, Colo.	4	4	None[1/]

* Only one comparable project found

1/ No comparable projects found

NOTE: Detroit field office excluded due to lack of complete data.

The number of conventional projects containing three-bedroom units used for comparison totalled 52, about half of our overall sample, because additional projects containing such comparables were not available nearby. Further, the differences between one-bedroom and three-bedroom and two-bedroom and three-bedroom rents assigned for Section 236 projects were found to be smaller than conventional rent differences for such units. We did not make a comparison of four and five-bedroom units because we could not find enough conventional projects containing four and five-bedroom units to make a comparison meaningful.

The differences shown in a few field offices may not be representative due to extreme local circumstances. For example, the soft housing market in the Seattle area has caused conventional rents to decline. Also, two of our test projects in Pittsburgh were rehabilitation projects in the inner city area and we had difficulty finding comparable non-HUD rehab projects.

Notwithstanding isolated peculiar circumstances, we believe the results of our study clearly show that Section 236 market rents are disproportionately higher than comparable size and location conventional rents.

In our opinion, the above disparities would have been greater had values been established and applied relative to convenience to shopping and social services and the general value attributable to established better neighborhoods in which the conventional projects are usually located. As the subsidized tenants move up the economic ladder, a disparity in the value received for higher rents paid make the Section 236 projects less attractive than comparable conventional housing, and a migration of economically successful tenants may follow.

Essentially, the mortgage amount and the cost of operating and maintaining a project are the major factors that influence project rent amounts. Accordingly, a net reduction occurring in either factor can result in a rent reduction. Also, since rent supplement payments cover the deficiency between 25 percent of the participating tenants' adjusted income and established basic rents, it follows that basic rent decreases will also decrease Federal rent supplement payments.

On the other hand, excepting the interest rate, the mortgage amount is the principal influencing factor on interest assistance payments. For example, given a project with an 8 percent interest rate (the average on our 62 selected projects), for each $1 included in the mortgage, HUD can expect to expend about $2 for interest assistance during the 40-year mortgage period.

Based on the above, costs included in the mortgage amounts should be absolutely essential if HUD is to effect economies in interest assistance payments and to allow the Section 236 tenants to enjoy the lowest rents practicable.

We believe certain types of costs such as architectural fees, inspection fees, MIP during construction, consultant fees, and incentive allowances could be reduced or eliminated without adversely affecting the Section 236 program. Our comments on these matters follow:

a. <u>Excessive Architectural Fee Allowances</u>

Because existing operating procedures have not been effectively applied, architectural fee allowances on Section 236 projects may have exceeded local customary allowances by about $2 million on our 62 test projects.

HUD's operating procedures (FHA Manual 72705.3(8)) provide that the allowance for architectural design and supervision fees "...shall represent the typical fees paid for projects of similar design and for services rendered." The procedures also state that "field data will be obtained as design and local practice dictates. Design and/or supervision charges may be based on percentage of costs, per room, per living unit, per building, per story, etc." Further, the Manual procedures include a tabulated schedule of percentage architectural design and supervision fees. The schedule is offered for comparative purposes and "...under no circumstances is it to be used for selection of fees."

Section 72705.3 of the Manual also requires that each field office conduct comprehensive surveys annually to assure that amounts allowed are in line with local custom.

Notwithstanding the above-cited operating procedures, we found that in general the field offices did not gather and use field data that depicted local

practice. When survey data was available in the field office, we found it to be comprised of previous HUD allowances on insured projects. Since data from outside sources was not used in the surveys found, we concluded that such surveys were not representative of local practice.

We found that wide variances existed in the amounts of architectural fees allowed both in processing and at cost certification, particularly when the fee amounts are expressed on a "fee per dwelling unit" basis. Architectural fees allowed ranged from $59 per dwelling unit (D.U.) to $889 D.U. The following tabulation shows the variance in more detail for 48 of the 52 test projects that had been finally endorsed at the time of our audit.

Architectural Fees for Design and Supervision (per D.U.)	Number of Projects
$125 and under	3
126 - $225	3
226 - 325	5
326 - 425	7
426 - 525	14
526 - 625	12
626 and over	4

To obtain an understanding as to how the conventional market makes allowances for architectural fees, we interviewed mortgage brokers, and/or architects and independent cost estimators in nine selected major cities. A Dallas, Texas, broker told us that in the Dallas area architectural fees for both design and supervision were customarily allowed in amounts between $75 and $125 per D.U., with a $125 per D.U. being the maximum allowable. By contrast, for the three test projects that were insured by the Dallas field office architectural fees averaging about $499 per D.U. were allowed, or about

$374 per D.U. more than would have been allowed by the mortgage broker we interviewed. Since the test projects totalled 656 D.U.s, it appears excessive architectural fee allowances on the three projects may have been incurred up to about $245,000.

A San Antonio mortgage broker told us that conventional architectural fee allowances in that area approximated $100 a D.U. for design. Considering architectural supervision costs, we estimated that the comparable conventional allowance in the San Antonio quotation was about the same as the $125 per D.U. Dallas quotation. Accordingly, with an average test project cost of $415 a D.U. and total units of 670, we computed possible excessive fee allowances of up to about $190,000 on the three test projects.

Our discussion with a conventional mortgagee and independent cost estimators in Atlanta, Georgia, disclosed that an average D.U. design and supervision fee of about $225 would be considered typical. The average HUD architectural fee allowances on our three test projects was $331, an excess of up to about $45,000 for the 432 D.U. in these three projects.

In Hartford, Connecticut, our interviews indicated a typical local fee of about $145 a D.U. compared with an average HUD allowance of about $439 a D.U. For the 665 D.U.s included in our three projects the total excess was up to about $195,000.

Mortgage brokers and architects were also interviewed in five additional localities. However, the information obtained was not sufficiently specific for our use.

Our national test showed that on the average architectural fees were $434 for each Section 236 D.U. constructed --- $209 a D.U. more than the highest fee considered typical in the four localities discussed above. Since about 9,450 D.U.s were included in our test, the total excessive architectural fees could be up to about $2 million.

Some individuals interviewed during our review referred to "extra architectural services" required on HUD insured projects as opposed to conventional projects. However, we were unable to either satisfactorily identify the "extra services" or obtain satisfactory estimates of their cost.

Based on the above, we believe that existing operating instructions have not achieved the goal of reasonable and customary architectural fee allowances. In our opinion, a significantly greater emphasis and effort is necessary to obtain and apply quality data and data analysis.

The Assistant Secretary, Housing Production and Mortgage Credit, has agreed that there is a need for comprehensive data as a basis for architectural fee allowances.

b. Eliminate Certain HUD Fees

Each mortgage includes an amount equal to .5 percent of the mortgage for HUD inspection fees and .5 percent per annum for mortgage insurance premiums (MIP) during construction. For example, a profit motivated project costing $1.4 million produces an insured mortgage amount of up to $1.26 million. Assuming a construction period of 12 months, the mortgage would include up to $12,600 for HUD inspection fees and MIP. For the total of 3,800 Section 236 projects in various stages of development representing $6.6 billion in actual or

potential insured mortgages, we estimate that HUD's interest assistance liability resulting from HUD inspection fees and MIP during construction will amount to more than $100 million.

Since the inclusion of the HUD fees generate a potential expense over the mortgage life of about twice the amount collected (at the 8 percent average interest rate on our test projects), we believe the continued assessment of such fees and resultant inclusion in the mortgage amount is illogical.

c. Reexamine the Need for Housing Consultants

Fees for project consultants were allowed to be included in mortgage amounts, even though the consultants may not be essential to project development.

Independent consultants were retained by 8 of 16 nonprofit projects included in our test. The fees allowed ranged from $15,000 to $27,500 and totalled $175,437. In addition to the consultant fees, each project mortgage included allowances for legal and organizational expenses.

Our discussion with field office personnel disclosed that it is generally understood that a consultant primarily serves as a project "packager." That is, the consultant locates an interested nonprofit sponsor and then assists the sponsor in preparing a project application and in dealing with HUD. Thus, the services provided were considered to be similar to the types of expenses

categorized by HUD as organization expenses. Accordingly, we compared the legal and organization expense allowances on projects processed with consultants to projects processed without consultants. The comparison was made to determine whether fee consultants contributed to a cost savings.

For the 16 projects the following legal and organization (L&O) and consultant fees were allowed in processing:

Projects With Consultants				Projects Without Consultants		
Project	Mortgage Amount (000)	L&O	Consultants' Fee	Project	Mortgage Amount (000)	L&O
A	$ 1,916	$ 4,500	$ 21,277	I	$ 1,653	$10,000
B	3,247	9,500	22,500	J	1,071	6,000
C	2,505	11,650	20,260	K	2,809	16,476
D	1,623	5,000	15,000	L	3,059	11,715
E	2,952	4,500	27,000	M	3,837	15,500
F	3,154	15,375	27,500	N	489	2,500
G	1,927	10,950	21,900	O	2,808	14,390
H	3,523	7,500	20,000	P	884	8,750
Totals	$20,847	$68,975	$175,437		$16,610	$85,331

As shown above, fee consultants did not materially effect a cost savings in the L&O expense category, particularly when compared to the consultant fees allowed. In fact, on a mortgage dollar amount basis, L&O expenses on projects without consultants were less than half of the L&O and consultants' fees on projects with consultants.

We also compared the processing time lapse between receipt of the feasibility application and the issuance of the firm commitment. Our comparison showed that projects without fee consultants were processed, on the average, in about 8.3 months while projects with consultants were processed in about 9 months.

The use of fee consultants by nonprofit sponsors is permissive rather than mandatory, and as shown in the foregoing tabulation one-half of the 16 non-profit projects were found acceptable to HUD without consultants. A fact that we believe indicates fee consultants are not essential to acceptable project development.

Giving due consideration to the expertise available on the HUD staff, we believe that projects can be successfully developed without the use of consultants and thereby effect significant economies in mortgage amounts and HUD's interest assistance liability.

The Assistant Secretary, Housing Production and Mortgage Credit, did not agree that consultants should be removed from the program because their services are essential to provide housing in certain locations and to reach the intended user group. He did agree, however, that a closer scrutiny of the consultant/sponsor relationship is in order and that restrictions should be imposed on the separate fee for consultants. In this regard the Assistant Secretary advised us that a study of consultant use and charges in the subsidized multifamily program was in process.

We recognize that on occasion housing consultants may provide a useful service. We believe, however, that the use of consultants could be precluded to a large extent by utilizing expertise available on the HUD staff to assist nonprofit sponsors in the development of project proposals.

d. Discontinue Incentive Allowances

Incentive payments totalling about $451,000 were paid to builders of 10 nonprofit projects examined in our test. In our judgment many of the incentive

payments were not necessary to successful completion of the projects we reviewed.

Under cost plus fee type contracts, builders are allowed to share in "cost savings" when certain actual costs are less than HUD's estimated costs. For nonprofit sponsors the incentive permissible is "not to exceed 50 percent." In practice, however, we found that the maximum 50 percent was consistently allowed.

Our audit confirmed the Regional Administrators' memorandum reports to the Secretary issued during September 1971 to the effect that (1) data banks were generally incomplete, obsolete, or nonexistent, and (2) construction costs and construction periods were consistently overestimated.

Under HUD's estimating system, historical cost data is the vital ingredient to achieve reasonable cost estimating. However, seven Regional Administrators reported that field office cost data banks were deficient. In the absence of current and reliable historical data, HUD's cost estimating capability becomes totally reliant upon the individual estimator's knowledge. In our opinion, such an unbusinesslike approach to cost estimating is not an acceptable basis on which to determine incentive allowances.

We examined the incentive payments paid on 10 of 16 nonprofit projects included in our test. As noted above, incentive payments on the 10 projects totalled about $451,000, representing about 2 percent of the $23.5 million total mortgage amounts. Since the incentive payment was generally 50 percent of the difference between estimated and actual costs, then the actual over-estimate of total project costs was about 4 percent. However, some project

costs, such as builders profit, architects fees, HUD's examination and inspection fees, and land values are not considered in the incentive payment computation. Therefore, we deducted the "nonparticipating" costs from total project costs and found that "participating" costs were actually overestimated about 5 percent.

The "cost savings" upon which incentive payments are based result, in our opinion, from overestimates in two major categories, i.e., project financing costs, which include interest, taxes, and insurance during construction, and project construction costs. Our review showed the following "eost savings" distribution between the two categories:

	Amount	Percentage
Financing Costs	$235,734	26
Construction Costs	554,630	74
Total	$901,364	100
50% Incentive Payments	$450,682	

The following examples illustrate unsound estimating practices under the "financing costs" category.

1. Mortgage Insurance Premium (MIP) Estimates

During processing, MIP is estimated on an annual basis, but at final endorsement is computed on a calendar day basis. Thus, a $1 million project with an estimated construction period of 13 months generates an estimated MIP for 2 years of $10,000. Assuming completion on schedule a "cost savings" of $4,582.50 would result, of which $2,291.25 would accrue to the builder.

2. Construction Time Estimating

As reported by the Regional Administrators, we also found a national pattern of overestimating construction time periods. As a result of discussions with HUD officials during our audit, we believe the practice of overestimating construction time has evolved in part from the following language included in the FHA Manual, Volume VI, Book 2, Paragraph 63522.

> "There are two main reasons for considering (mortgage) increases before final endorsement: (1) to correct substantial error in the original processing which would otherwise result in serious inequities, or (2) substantial changes in the approved plans and specifications that have resulted in significant betterments..."

Additionally, the cited Manual reference states that there should be no subsequent mortgage increases unless an identifiable benefit to HUD results and also states "...Normally no increase will be considered when the amount involved represents less than 2½ percent of the original mortgage amount."

Apparently, to avoid mortgage increases that may not comply with the above criteria and possibly to accommodate for unforeseen construction delays, we believe that the HUD processing staffs have acquired a quite liberal attitude toward estimating construction time with the obvious result of unwarranted incentive payments.

The following case study illustrates the effect of liberally estimated construction periods:

Project S, Topeka Field Office

The project builder was well known to the Insuring Office and had a history of completing comparable projects in less than 12 months. Notwithstanding his extensive experience with the Insuring Office,

the construction period was estimated at 15 months. The project was actually completed in 8 months. Although no cost savings in construction costs were realized, the builder was allowed $25,153 incentive payment computed as follows:

Classification	Estimated Costs	Actual Cost	Underrun
Interest During Construction	$ 87,821	$53,283	$34,538
Property Taxes During Construction	4,500	725	3,775
Insurance During Construction	8,000	6,453	1,547
MIP During Construction	16,531	6,085	10,446
Totals	$116,852	$66,546	$50,306
Incentive Payment @ 50 percent			$25,153

Based on our review, we have concluded that in lieu of effecting cost savings and reduced construction time, as intended, the incentive payment provision has resulted in increased project costs; thus, increased mortgages.

The Assistant Secretary, Housing Production and Mortgage Credit, has indicated that a new look at incentive payments is appropriate, and advised us that a reevaluation of the incentive payment provisions and construction cost plus fee contracts was in process.

e. Premature Project Advances

Unnecessary interest costs were included in mortgage amounts because construction funds were advanced at the beginning of construction for cost items that did not become due and payable until after project completion.

Each project includes as amount currently equal to 1.75 percent of the mortgage amount representing Federal National Mortgage Association (FNMA) fees for their purchase of the mortgage. A fee of 1.75 percent of the original estimated mortgage amount is allowed in processing pursuant to

Paragraph (19)(d) of the Mortgagee's Certificate. Specifically, the fee covers the following types of FNMA services:

Percent	Description
.25	Preliminary commitment fee based on the original mortgage amount and due and payable on execution of the preliminary commitment contract, which is prior to initial endorsement. A .125 percent fee is charged for each three month commitment period.
1.00	Firm commitment fee based on the original estimated mortgage amount and due and payable on execution of the firm commitment contract, which is prior to initial endorsement. The firm commitment contract covers two years and an additional .125 percent charge is made for each three months extension.
.50	Purchase and marketing fee based on the outstanding principal balance of the mortgage at the time purchased by FNMA, and due and payable at time of purchase.
1.75	

Although the .5 percent purchase and marketing fee is not due and payable until after final endorsement, the practice is to advance the total FNMA financing fee immediately following the initial mortgage endorsement (mortgage proceeds advance No. 1). The advance is made under authority of Paragraph 73022.2 of FHA Manual, Volume VII, Book 2, which provides that mortgage proceeds for the fee that are due "...prior to or at closing may be approved for advance immediately following the initial endorsement of the credit instrument." (Underscoring supplied.)

For 59 projects included in our test the FNMA purchase and marketing fee (.5%) totalled $656,831. Using a 12-month construction period and an average mortgage interest rate of eight percent, we estimate that about $52,000 interest was unnecessarily included in mortgage amounts.

We also noted other types of project costs for which advances were approved even though all or a portion of the costs had not been incurred by the mortgagor. Our observations were made particularly in the area of off-site costs and legal expenses.

In our opinion, a policy prohibiting the approval of construction advances on other than a "due and payable" basis would contribute to reduced project costs.

f. Off-site and Demolition Costs

Due to an inconsistent definition as to what types of costs are included in the cost of land, 25 builder/sponsors included in our test have received Builders' and Sponsors' Profit and Risk Allowances (BSPRA) totalling about $37,000 relating to off-site improvements. We believe such allowances are improper and the regulations should be clarified.

The application processing stage of a project includes estimating total project costs. As a part of cost estimating, HUD ascribes a value to the proposed project site in a fully improved condition. Accordingly, HUD's ascribed land value is considered to be a fair estimate of site value with all necessary demolition work completed, and public utilities and streets (off-sites) available at the site boundary. When the necessary off-sites have not been installed at processing, the off-sites are required to be installed at the mortgagor's expense; therefore, the cost of providing off-sites is not included in the total estimated development cost, which does not include the ascribed land value. Since the 10 percent BSPRA is allowed on the estimated development cost, the BSPRA allowance is not affected by the cost of off-sites during the processing stage.

During the cost certification and review stage of the project, a different approach is taken to land cost which effectively, (1) reclassifies off-sites and demolition costs from land cost to development costs, and (2) permits the builder to receive the 10 percent BSPRA allowance on the off-site and demolition costs.

At cost certification the builder/sponsor certifies to the actual off-sites and demolition costs. The costs are then grouped with total development costs and the 10 percent BSPRA allowance is applied.

The following hypothetical cases illustrate the two methods described above and their effect on total project cost. In both examples, the fully improved value of the land is the same, $300,000. However, in Example No. 1 $100,000 of off-site work necessary to bring the land to a fully improved condition had not been accomplished at the feasibility stage. In Example No. 2 the land was fully improved at feasibility processing.

Description	Example No. 1	Example No. 2
Total Development Cost	$2,000,000	$2,000,000
Add Off-sites and Demolition	100,000	None
Subtotal	2,100,000	2,000,000
BSPRA @ 10 percent	210,000	200,000
Land Valuation	200,000 1/	300,000
Total Project Costs	$2,510,000	$2,500,000

1/ Termed "As Is" value and computed by deducting off-site costs from ascribed value fully improved.

Section 227 of the Housing Act states in part that BSPRA will be allowed on the total project "...'actual cost' except land..." As it pertains to those

costs to which the builder/sponsor must certify, Section 227 clearly includes off-sites as part of certifiable "actual costs." However, the "land" to be excluded under the BSPRA computation is not further defined in Section 227.

HUD's interpretation of the Section 227 is expressed in FHA Regulations - Project Mortgage Insurance, and, as applied, the method illustrated above in Example No. 1 is used.

In our opinion, off-site and demolition costs are properly allocable to the cost of land and, therefore, are encompassed in the "land" exclusion of Section 227. Accordingly, related costs such as BSPRA, that result from off-sites are not properly allowable as a project cost.

g. Federal Wage Requirements

During our review several HUD officials and members of the private sector expressed the opinion that because of Federal wage requirements the cost of constructing Section 236 projects was materially higher than the cost of conventionally financed projects. We did not examine into the impact of Federal wage requirements on the Section 236 program. In view of the various comments, there is a strong possibility that, as administered, the existing Federal wage requirements adversely affect Section 236 construction costs when compared with conventional construction costs.

Recommendations

To effect economies in interest assistance payments and to allow Section 236 projects to be more viable, we recommend that the Assistant Secretary, Housing Production and Mortgage Credit:

1. Require each field office to annually (a) canvass all major mortgage brokers, architects, and builders, who deal in the conventional market to determine typical methods used and amounts allowed for architectural fees in the conventional market; and (b) based on an analysis of the data gathered, with consideration to HUD requirements, establish maximum fee allowances for each principal locality.

2. Conduct a comprehensive study of architectural services required by HUD as compared to services utilized in the conventional construction industry for the purpose of determining whether HUD's requirements are more than needed and reduce such requirements accordingly.

3. Establish a policy that will effectively waive the charge for and collection of the HUD inspection fee and MIP during construction on Section 236 projects.

4. Reexamine the need for services provided by housing consultants to ascertain whether such services are essential to project development.

5. Prohibit the use of incentive payment provisions in cost plus fee type contracts until assurance is obtained that data banks are currently and completely maintained and the cost estimating process has been improved.

6. Establish a policy prohibiting the approval of construction advances on other than a "due and payable" basis.

7. Issue a policy determination to the effect that off-site, demolition, and unusual land improvement costs cannot be included in the base cost for BSPRA computation.

FINDING NO. 2 - IMPROVE COST CERTIFICATION REVIEW SYSTEM

Because of deficient operating practices pertaining to the reviews of Certificates of Actual Costs we found that (1) ineligible and questionable construction and other costs were allowed, (2) supplemental cost certifications were not obtained, and (3) identity of interest subcontractors were not instructed to submit required cost certifications. As a result, actual costs were overstated, builders/sponsors received unwarranted funds, mortgage amounts were inflated, and unnecessary interest subsidy payments were and continue to be made. We believe that the deficiencies can be attributed to the lack of training and unfamiliarity with Manual requirements.

Section 227 of the National Housing Act requires a mortgagor of a multifamily housing project to submit a cost certification upon completion of the physical improvements, but prior to final endorsement of the mortgage instrument for insurance. Where an identity of interest exists between a mortgagor and contractor or sponsor and contractor, cost certifications are required of both mortgagor and contractor. This also applies to a nonprofit mortgagor irrespective of whether an identity of interest exists.

Also, each subcontractor, material supplier, or equipment lessor, having an identity of interest with either the mortgagor or general contractor, is required to submit a certification of his actual costs. Each cost certification submitted by a mortgagor or contractor, must be accompanied by an unqualified certificate of an independent certified public accountant or a licensed independent public accountant.

HUD cost certification review procedures provide generally that all costs relating directly to construction are reviewed by the Cost Section and other costs such as interest, taxes, financing fees, and legal and organizational costs are reviewed by the Mortgage Credit Section. The FHA Manual, Volume 7, Book II, Paragraphs 72709 and 73029.7, states that the purpose of reviewing the cost certifications is to determine the reasonableness of the amounts shown. Reasonableness of certified amounts is to be based upon project cost estimates and data bank information on the current general level of costs.

a. Allowance of Ineligible and Questionable Costs

Our examination of field office records on 52 projects involving insured mortgages totalling about $111 million for which cost certifications were submitted disclosed that for 21 projects ineligible costs of about $344,000 and questionable costs of about $281,000 were allowed. We made separate audits of the builder/sponsor records on three projects included in the 21 noted above and recommended cost disallowances of $425,000, about 4 percent of the mortgage amounts on those projects.

As a typical deficiency in the field office cost certification review process, we found that the Seattle field office, on one project, allowed ineligible costs of $56,423 in excess of the amount approved in processing. The Project Income Analysis and Appraisal, FHA Form 2264, processed at the firm commitment stage showed that costs of $103,597 would be allowable for architectural fees. Of this amount, $77,642 represented architectural design services and $25,955 represented architectural supervision services.

The Agreement and Certification, FHA Form 3305, entered into between HUD, the mortgagor, and mortgagee further provided that the maximum architectural fees for design services allowable for cost certification purposes would

be $77,642. The Owner-Architect Agreement entered into between the mortgagor and architect, however, provided for compensation of $160,000 for architectural design and supervision services. Architectural costs of $160,000 thus were included in the Mortgagor's Certificate of Actual Costs and the full amount was allowed in the cost certification review process.

We believe that the total costs of $103,597, determined to be reasonable and customary for the locality during processing of the application, which included the maximum design fee of $77,642, stipulated in the Agreement and Certification effectively limited the amount allowable for cost certification.

The allowance of $160,000, therefore, resulted in the approval of $56,423 of additional costs. The architectural fees allowed for this project represented 8.26 percent of actual costs or $889 per dwelling unit, both of which were far in excess of typical allowances on other projects.

In another project, we found that the Sacramento Insuring Office improperly applied the provisions of Circular HPMC-FHA 4205.15 in their review of the Mortgagor's Cost Certificate.

The Circular provides for offsetting any savings in carrying charges, i.e., interest, taxes, insurance, and mortgage insurance premiums against overruns in construction costs. Essentially, the Circular allows a dollar for dollar substitution of savings for cost overruns. For example, if the contractor overruns the stipulated contract price (upset amount) by $10,000 in otherwise eligible costs, he may be reimbursed up to this amount provided there is a

savings in carrying charges equal to or greater than the overrun. We found, however, that the Sacramento Insuring Office allowed the full amount of savings, $30,460, while the contractor's overrun was only $188. Consequently, ineligible costs of $30,272 ($30,460 - $188) were allowed. In addition, builder's and sponsor's profit and risk allowance (10%) of $3,027.20 was allowed on the ineligible costs for a total ineligible amount of $33,299.20.

The acceptance of ineligible costs in cost certifications results in excess profits to builders and sponsors, inflates the mortgage amount, and increases the Government's interest subsidy payments. Additionally, the nondetection of ineligible costs has a continuing harmful effect because such costs are included with other costs and are used as a basis for cost estimation on future projects, and also serve as a measuring stick for determining the reasonableness of costs on other projects.

b. <u>Supplemental Cost Certifications Not Obtained</u>

We found that field offices were not aware of the extent of outstanding or overdue supplemental cost certifications covering unpaid and/or estimated costs included in the mortgagor's and contractor's cost certifications. In our review of 32 projects for which supplemental cost certifications were due, we found that such certifications covering $5,488,000 in mortgagor's costs and $4,203,000 in contractor's costs were not obtained. As a result, the field offices have no assurance that mortgage amounts were based on actual costs as unpaid obligations and estimated costs may be discounted or otherwise reduced.

Instructions in FHA Manual, Volume VII, Book 2, Paragraphs 73030.2 and 73031, provide that mortgages shall not exceed the applicable percentage of <u>actual</u>

costs, and that where mortgage amounts were based on cost certifications which included unpaid or estimated costs the later substitution of actual costs may require a reduction in the mortgage amount. These instructions also provide that the supplemental cost certifications must be submitted by the mortgagors within 60 days after final endorsement and that the field offices must establish follow-up procedures for obtaining them. The Manual further provides that the supplemental cost certifications shall be reviewed under the same procedures as followed in the review of the Certificates of Actual Costs.

Our review confirmed the findings of a Central Office review team, which examined Section 236 activities of five field offices, and reported that, generally, supplemental cost certifications were not being obtained. We found that all offices we visited were lacking in established procedures for obtaining and reviewing such certifications. In some offices, we noted that the responsibility for obtaining and reviewing the certifications was placed with the Property Management Section, on the assumption that all activities occurring after final endorsement were a function of that section.

Notice HPMC-FHA 71-30, dated July 16, 1971, emphasized the necessity for obtaining and reviewing supplemental cost certifications and placed this responsibility on the Area Office Finance and Mortgage Credit Section or the Insuring Office Mortgage Credit Section. We noted, in some offices, that steps had been taken to assure corrective action.

Insofar as the problem was widespread and not limited to a few offices, we believe that more effective action other than emphasizing

established Manual procedures is necessary. Therefore, we suggest that at the time of final endorsement all amounts of unpaid cost by the mortgagor/sponsor be escrowed. If evidence is not obtained that such liabilities were paid at the expiration of the period for obtaining supplemental cost certifications, the mortgagee should be advised to apply such amounts towards a reduction of the mortgage principal.

c. Cost Certifications Not Obtained for Identity of Interest Subcontractors

The FHA Manual, Volume VII, Book 2, Paragraph 72707, provides that when an identity of interest exists between the mortgagor, contractor, and any subcontractor, material supplier or equipment lessor, they are required to certify their actual costs. They are also required to certify their actual costs when they have an identity of interest with the general contractor and the general contractor is required to certify his actual costs.

We found a number of cases where field offices were not requiring the submission of cost certifications from identity of interest subcontractors. At the Hartford, Conn., Insuring Office (now Area Office) our review of three Section 236 projects disclosed that costs totalling $2,229,169.50 involving identity of interest subcontractors were not certified and there was no indication that action had been taken to obtain the certifications. A breakdown of these costs is shown below:

Project	Subcontractor	Trade Item	Amount
1	A	Painting	$ 77,408.77
	B	Plumbing, Heating and Duct Work	449,742.04
	C	Concrete	119,646.33
2	A	Painting	89,061.78
	B	Plumbing, Heating and Duct Work	517,144.07
	C	Concrete	137,657.61
3	D	Carpentry, Windows, and Doors	803,508.90
	E	Lawns and Planting	35,000.00

The need to obtain and review cost certifications from identity of interest subcontractors is exemplified by the wide variances in the square foot costs shown in the following illustration concerning Project 3 above.

Trade Item	Square Foot Cost of Comparables	Square Foot Cost of Subject[1]	Percentage Increase Over Comparables
Rough Carpentry	$1.583	$1.978	25.0%
Rough Carpentry	1.723	1.978	15.3%
Finished Carpentry	.499	.611	22.4%
Finished Carpentry	.447	.611	36.6%

In our opinion, unless the subcontractors' certificates of actual cost are obtained and reviewed in conjunction with the Mortgagor's and Contractor's Certificates the field offices have no assurance that construction costs are proper and that mortgage amounts are properly computed. Area Office personnel responsible for reviewing cost certifications advised us that they were not aware that the identities of interest existed.

Similarly, at the Atlanta Insuring Office (now Area Office), we noted that two identity of interest subcontractors did not submit certifications on subcontracts totaling $223,562. Field office personnel advised us that they were not aware that cost certifications were required.

We believe that the above examples point out the general lack of training and unfamiliarity with Manual requirements on the part of operating personnel.

d. Lack of Assigned Responsibility to Assure Detection of Identities of Interest

The cost certification reviews are not sufficiently comprehensive to assure that identities of interest, particularly between general contractors and

1/ The cost certification was obtained after our inquiry; however, it was not prepared in accordance with applicable instructions.

subcontractors, are detected when such identities have not been previously disclosed. As a result, for 6 of the 62 projects reviewed, cost certifications for identity of interest subcontractors were not obtained and there was no assurance that actual costs were accurately stated and that subcontractors general overhead and profit percentages were not excessive.

HUD procedures are based on self-disclosure of any identity of interest between mortgagors, general contractors, and subcontractors. An identity of interest, generally, is any relationship which would give the general contractor control or influence over the price paid to the subcontractor. Usually this would be by the general contractor having a financial interest in the subcontractor or a family relationship. Where such an identity of interest exists and the general contractor is required to submit a certification of actual costs, the subcontractor, likewise, is required to submit a certification.

Our reviews disclosed that identities of interest existed in connection with the six projects shown below. Such identities, however, were neither previously disclosed by the contractor nor detected by field office personnel responsible for reviewing cost certifications.

Area/Insuring Office	Project	Identity of Interest	Contract Costs
Camden	A	Mortgagor/General Contr./Sub. Contr.	$216,430.04
	A	" " " " "	18,631.92
	A	" " " " "	59,000.00
Camden	B	" " " " "	222,000.00
	B	" " " " "	15,000.00
	B	" " " " "	58,000.00
Oklahoma City	A	General Contr./Sub. Contr.	500,000.00
San Antonio	A	" " " "	23,000.00
Indianapolis	A	Mortgagor/General Contr./Sub. Contr.	189,637.50
Denver	A	General Contr./Sub. Contr.	216,150.22

In connection with the Indianapolis project, we found that the costs claimed by the general contractor for subcontract drywall work were substantially higher than the costs incurred for similar type work on the other projects. The field office files showed that on six comparable projects such costs ranged from $.57 to $.68 a square foot whereas the costs on the subject project were $.98 a square foot. Using the highest comparable ($.68), we estimated that questionable costs of about $58,000 were claimed and approved.

The Agreement and Certification, FHA 3306 and 3306A, required that the mortgagor disclose any identity of interest that exists between the mortgagor or any of its officers, with the architect, general contractor, subcontractors, suppliers or equipment lessors. Similarly, the Certificates of Actual Costs (FHA Forms 2330 and 2330A) submitted by mortgagors, general contractors, and subcontractors require certification as to whether or not any identities of interest existed. Penalties under the provision of the U.S. Criminal Code, Section 1010, Title 18, U.S.C., are applicable in connection with these certifications. We have referred these cases to the appropriate Office of Investigation field offices.

We detected the above identity of interest cases through our review of documentation in the respective project files. The nondetection of these identities of interest was discussed with field office personnel and we pointed out that greater attention on their part to this matter would have resulted in such detection. We were advised generally to the effect that sufficient staff was not available for this type of review. We believe, however, that there is a need for greater concern on the part of cost reviewers and that total reliance should not be placed on the system of

self-disclosure. The nondetection of identities of interest may stem also from the fact that cost certification review procedures are silent regarding the establishment of controls, or responsibilities, to assure that all such identities are detected. As discussed previously even when such disclosures are reported, sufficient efforts are not made to obtain the required certifications.

Because of the number of cases of undisclosed identities of interest noted in our reviews, we believe that there is a need for additional controls along with the assignment of specific responsibilities to assure that all such identities of interest are reported and appropriate cost certifications obtained.

Recommendations

To assure that actual costs are properly ascertained, unwarranted profits are precluded, mortgage amounts are properly computed, and interest assistance payments are proper, we recommend that the Assistant Secretary for Housing Production and Mortgage Credit take action as necessary and appropriate to:

1. Advise field office personnel of the need for more comprehensive reviews of cost certifications with particular emphasis placed on the detection of nonallowable costs.

2. Revise Manual instructions to provide that at the time of final endorsement all items of unpaid cost by the mortgagor/sponsor be escrowed. Further, if such costs are not paid within the stipulated time advise the mortgagee to apply the escrowed amounts towards a reduction of the mortgage.

3. Require the Cost Sections of field offices to make written positive determinations that cost certifications have been received and approved for all identity of interest subcontractors. Also, revise Manual instructions to assign the responsibility to field office Cost Sections for establishing the necessary controls to assure that all identities of interest are detected.

FINDING NO. 3 - NEED FOR IMPROVED DATA BANKS

Our review of Section 236 activities at 21 field offices disclosed generally that data banks were inadequate because data contained therein was outdated, incomplete, and otherwise unreliable for the purposes intended. Consequently, numerous Section 236 projects were processed, developed, and constructed without substantive documentary evidence or data supporting the bases for estimated construction costs, projected operating expenses, ascribed land valuation, and derived marketability. As a result, some sponsors who held land for relatively short periods of time have made large profits on land, construction costs have been inflated, projects have defaulted, and other projects have experienced difficulties due to built-in default conditions.

Data is defined by HUD as "facts and figures from which conclusions can be inferred." Data banks, therefore, are files containing facts and figures on land sales, project operating expenses, construction costs, apartment occupancy rates, etc., along with various sundry general and specific information relating to the nation, the region, metropolitan areas and specific localities.

HUD instructions require all field offices to maintain adequate and current cost, valuation, market, architectural, and mortgage credit data banks to assure rapid processing of applications.

The multifamily project processing system is wholly dependent upon current and complete data banks. Without current and complete data, the processing system is then based on informed guesswork. In this regard, the FHA Manual Volume VII, Book 2, Paragraph 72423.2, cautions that "underwriting

conclusions and recommendations are no better than the data upon which they are based." Our reviews showed that weaknesses existed in the performance of functions in most stages of the processing system dependent on data banks.

a. Underestimated Operating Expenses

A consistent pattern of underestimated project operating expenses was noted in our review at 17 of the 21 field offices. We found that such underestimates resulted primarily from outdated and incomplete data bank information.

Sponsors of multifamily housing projects include only an estimate of the total annual operating expenses of the proposed project in their applications for project mortgage insurance in accordance with HUD instructions for the feasibility stage of processing. The validity of the estimate is required to be confirmed during subsequent stages of processing. The HUD estimate is to be based on an analysis of total expenses of comparable properties from information contained in the data bank and is shown on a per unit per annum basis. Lump sum dollar adjustments are made for significant differences between the comparables and proposed projects and an adjustment for trend is made to allow for changes until the project is completed.

We found that the data banks, in many cases, had not been updated for over two years and, consequently, the estimates based thereon did not reflect the upward trend of operating and maintenance costs. At the San Antonio field office, we noted that data banks containing actual expense information had not been established. As a result, the expense estimated did not realistically

depict the expenses of maintaining a project and could influence the approval of an otherwise unsound project.

At the Sacramento Insuring Office, we found that the annual operating expenses for one project were underestimated by about 50 percent. Possibly, as a result of this underestimate, the project subsequently went into default and has since been assigned to the Secretary. We believe that if the annual expenses were realistically estimated during processing an expense ratio in excess of 80 percent of basic rental income would have been indicated showing that the project was not financially feasible.

A Central Office task force reviewed Section 236 activities at five field offices and reported that operating expenses were consistently underestimated. The task force noted that estimated expenses for taxes, insurance, and utilities bore little resemblance to the actual expenses. In replying to the Secretary's telegram of August 12, 1971, expressing his concern relating to underestimated operating expense estimates various Regional Administrators generally concluded that field offices frequently underestimated the expenses. Field office officials advised us that the prime reason for the inadequate data banks was the general lack of sufficient staffing. We found that data appraisers, responsible for maintaining data banks, frequently were assigned to other processing duties. Typically, the emphasis in the field offices was on production with the concomitant effect that other duties, such as data gathering, were allowed to slide or were not performed in many cases. Most of the projects we reviewed were in operation less than one year; consequently, there was insufficient information available to correlate

actual and estimated annual expenses. Our reviews disclosed, however, that most projects incurred expenses at a rate that exceeded the rate of estimated expenses.

As noted above, processing instructions for estimating expenses require the use of total expenses based on data of comparable projects. Because of the preponderance of projects processed with underestimated annual expenses and the potential harmful effects therefrom, i.e., need for rental increases and potential default conditions, it is necessary to place additional emphasis on obtaining more realistic estimates to assure the viability of proposed projects. To this end, we believe that the HUD processing instructions need to be modified to require an in depth analysis and estimation of all significant components of the annual expenses that comprise the total. In addition, current instructions to applicants need to be revised to require a similar detailed breakdown of expenses at the feasibility stage, insofar as many of the project sponsors have actual experience in operating and managing similar type projects.

b. Inflated Land Valuation

HUD estimates of land value made shortly after sponsors acquired the land generally exceeded the sponsor's cost. As a result some sponsors/mortgagors

have received large profits. We noted eight cases where, within one year of acquisition, land was valued at amounts that resulted in profits ranging from 65 to 195 percent above acquisition costs and related expenses.

In estimating land value, HUD procedures call for comparisons of the proposed project site with equivalent sites (referred to as comparables). It is intended that the dollar value assigned to the proposed project site will bear a relationship to the selling or listing prices of the comparables after giving consideration to the superiority or inferiority of the proposed site as compared with the comparables.

The procedures provide for the selection from data banks and recording of sites recently sold or offered for sale which are considered to be the most comparable to the proposed project site. For each comparable thus recorded, the sale or offering price per square foot and the date of such sale, listing, or offering must be shown. After selecting and recording the comparables, the valuator must compare the proposed project site with each of the comparables and determine whether, in his opinion, the proposed project site is superior, equal, or inferior to the comparable.

The procedures provide that the "As Is" value of the proposed project site be determined on the basis of (1) the selling or listing prices of the comparables and (2) the valuator's opinion as to the superiority or inferiority of the proposed site in comparison with the comparables, less the estimated cost of unusual land improvements, demolition, and off-sites. To the extent that the "As Is" value exceeds the sponsor's cost of acquiring the land, profit is allowed.

We noted that in many instances the comparables selected from the data banks provided little, if any, indication of the value of the project site. For many of the projects which we reviewed, the dissimilarity between the project site and the comparables used as a basis for valuing the site was so great as to make it unlikely that reasonably accurate land values could be obtained. In view of the weaknesses in the data banks evidenced by the comparables selected, we believe that excessive land values were established for many projects which resulted in undue increases in the amount of the insured mortgages.

We interviewed loan officials from four mortgage companies in San Antonio and Oklahoma City to ascertain conventional practices in valuing land for mortgage computation purposes. We were advised substantially to the effect that if the mortgagor acquired the land in the past year, the valuation on the land for mortgage purposes would be about the same as the mortgagor's cost. They said that they appraise the land and give consideration to its cost in arriving at a value for mortgage purposes. One official stated that if the mortgagor acquired the land in the past year, the valuation would be equal to his cost or not more than five percent higher.

Although HUD instructions require the sponsor (Mortgagor) to furnish information concerning the acquisition cost of the land, we found many cases where option prices were furnished or acquisition costs were not based on arm's-length transactions. In many cases the field offices did not have reliable evidence as to the sponsor's cost. The Chief Underwriter at one office told

us that he saw no need for obtaining information on the sponsor's cost because the value of the land is determined by HUD's valuation process and not by the cost to the sponsor.

In our opinion, HUD's requirement that land be valued on the basis of comparable parcels without adequate consideration of the actual cost coupled with inadequate data banks to select such comparables resulted in excessive land valuations and undue increases in insured mortgages.

The following eight examples of land valuations made within one year following the limited dividend sponsor's acquisition illustrate cases where excessive land values and undue increases in mortgage amounts resulted.

Project	HUD "As Is" Land Valuation	Sponsor's Cost	Gain	Profit (Percentage)	Date of Acquisition	Date of Valuation	Period Held
A	$128,150	$ 67,700	$ 60,450	89	1/68	1/69	12 mos.
B	307,000	167,625	139,375	83	12/67	12/68	12 mos.
C	144,500	48,900	95,600	195	8/69	11/69	3 mos.
D	254,000	153,129 1/	100,871	65	9/69	11/69	2 mos.
E	292,600	128,459 1/	164,141	127	9/69	11/69	2 mos.
F	305,500	143,750	161,750	112	3/69	8/69	5 mos.
G	148,547	86,600	61,947	71	11/68	12/68	1 mo.
H	223,700	116,520	107,180	92	4/68	12/68	8 mos.

1/ Contiguous tract acquired as one transaction; allocation of cost based on square footage after deducting value ascribed to land retained by sponsor.

Projects D and E

Three of the five comparables used were less than half the size of the subject sites. Two of these comparables were slightly larger than one acre in size, whereas subject sites were 15 and 18 acres, respectively. Documentation in the project files showed other comparable sales that were not in the data bank or used for HUD's valuation of subject sites.

Project F

Sponsor acquired 22.3 acres (commerical and multifamily) in March 1969 for $243,000. HUD valuation in June 1969 for 14.3 acres (multifamily) was $305,500. Regional Office review rejected valuation due to lack of documentation showing reasons for high valuation and use of outdated and greatly superior comparables. Upon revaluation, the Insuring Office used one of the same superior comparables, substituted another superior comparable and a comparable less than half the size of the subject site. Remaining comparables did not support the assigned value.

Project G

All five comparables were about half the size of the subject site. Four of the five comparables involved land acquired for other HUD projects. However, the valuator used the HUD assigned value instead of the actual sales price.

FHA Manual Volume VII, Book 2, Paragraph 72906.1 provides that comparables should be competitive to the subject site and be of adequate size to meet generally the requirements of the proposed project. In addition, valuation instructions contained in FHA Manual, Volume VII, Book 3, on the preparation of Form 2264, Project Income Analysis and Appraisal, provide that where the "As Is" value exceeds the total cost to the sponsor, a full explanation and documentation is required to be made a part of the file.

As shown by the above examples, we noted many instances where the comparable sites were not competitive and were of inadequate size to meet the proposed project requirements. In some cases the comparables represented sales transactions of single family residential properties while others represented sales of commercially zoned land. Further, we noted a general lack of compliance

with the instructions for preparing Form 2264, as there was little documentation explaining the valuators' reasons for higher valuations. In many instances the valuators' were unable to recall the reasons for adjustments made to the comparables used in support of the ascribed land valuation.

Based on the results of our review, we believe that there is a compelling need to restrict inflated land valuations and preclude large profits resulting therefrom by limiting the valuation to the lesser of HUD's "As Is" value or the sponsors' total acquisition costs including interest on the land investment.

c. Lack of Adequate Market Data

Because of the lack of complete and current market data during the application processing stage several projects which were infeasible, from a marketability standpoint, were developed. As a result, the projects are encountering vacancy problems which, in turn, may lead to default. In addition to the lack of meaningful market data, we believe that the undue reliance placed on the overall national housing shortage and the resultant stress placed upon production to meet the national needs as opposed to meeting a specific local need has contributed to this situation.

HUD instructions do not require prospective sponsors to submit any data, studies, or market information supporting the basis for the proposed project or otherwise justifying the need. Basic information for prospective sponsors

is contained in HUD Guide FHA G 4205.13 which provides that at the initial interview the sponsor shall be prepared to discuss in general terms the demand for the type of housing proposed, the extent of competition, the vacancy rates and market absorption of units at prevailing rent levels in the neighborhood. Upon receipt of an application for insurance, the HUD instructions require that the site and location be examined to determine suitability of the proposed project. Additionally, the FHA Manual, Volume VII, Book 2, Paragraph 72427.15, requires that during feasibility processing an analysis of the application be performed based on data bank information to determine whether a market for the project exists at that location in terms of the number of units, their sizes, composition, and proposed rentals.

Based upon an analysis of the data bank information along with any HUD economic and market analysis studies of the locality a determination can be made as to the marketability of a proposed project.

We found that economic and market analysis information had not been fully taken into consideration during feasibility processing. Data bank information was maintained currently at only a few field offices while at most other offices such data was either not maintained or had not been updated for a number of years. Although, appropriate check marks were made on FHA Form 2264, Project Income Analysis and Appraisal, indicating that there was a market for the proposed projects we found little documentation showing that an analysis of the market absorption in terms of the number of units, sizes, composition, or proposed rentals had been made. The lack of market data and other information available at most offices precluded an effective analysis of all matters

bearing on the potential success of a proposed project at the prospective location.

Twelve of the 62 projects included in our review had less than 90 percent occupancy. The following projects, available for occupancy for at least six months, were experiencing more pronounced problems attracting sufficient numbers of qualified tenants:

Project	Location	Units Available	Units Occupied	Occupancy Percentage
A	Waterbury, Conn.	230	144	62.6
B	Waterbury, Conn.	265	145	54.7
C	Griffin, Ga.	120	76	63.3
D	Everett, Wash.	202	174	86.1
E	Kirkland, Wash.	180	104	57.7

In addition to the above projects other field offices were experiencing "soft market" conditions. Further, we noted instances where new Section 236 projects were drawing tenants from older Section 236 projects as well as other HUD insured projects.

In connection with two projects in Waterbury, Conn., we found that the Hartford Insuring Office (now Area Office) simultaneously processed two applications from the same sponsor to develop two projects located on contiguous parcels of land. Feasibility of the projects had been determined by the Insuring Office on the basis of market data that, in our opinion, did not support either the number of units, sizes, composition, or proposed rentals. We found that the data bank information was not (1) currently maintained, (2) completely filled out, and (3) inclusive

of all projects in the locality even though this data was available. Field office personnel were unable to furnish us any evidence showing that an adequate market study had been made for this locality.

The two projects began initial occupancy in January 1971. At August 16, 1971, we noted that of the 418 two-bedroom units available at the two projects, 207 or 50 percent were vacant. Our review of the mortgagor activities further disclosed that 86 of the 211 occupied two-bedroom units were occupied by tenants that did not meet HUD criteria for two-bedroom occupancy. Consequently, the effective rate of occupancy, i.e., eligible tenants occupying two-bedroom units was only 30 percent. The mortgagors have submitted requests for a second modification of the mortgage agreement on behalf of both projects.

We also noted that feasibility letters on four additional Section 236 projects proposed for Waterbury had been issued. These four projects will provide an additional 236 two-bedroom units in a saturated market.

Because of the nationwide need for additional housing and HUD goals in this regard, we believe that field offices are processing applications for project insurance without adequate regard to the merits and need for the projects at the specific localities. In our opinion, there is a necessity for a more thorough analysis of project applications concerning both the merits and the need for the project. Such analysis is also needed in all areas and disciplines involved with processing, and can only be effectively performed with adequate and current data bank information.

Recommendations

To effect economies in project development, we recommend that the Assistant Secretary for Housing Production and Mortgage Credit,

1. Revise current instructions to sponsors so as to require sponsors to provide detailed information and estimates of operating budgets for the feasibility stage as well as conditional and firm commitment stages of applications for project insurance.

2. Advise field offices to implement processing instructions requiring a careful analysis of all sponsor estimates of operating budgets supplemented with in-house estimates based on valid data bank information.

3. Emphasize the need for stricter compliance by field offices with the requirements for preparing Form 2264 regarding documentation of land valuation and the need for greater care in selecting comparable land sales transactions.

4. Revise Manual instructions for valuing land for cost certification purposes at the lesser of the HUD estimated "As Is" value or the actual arm's-length cost, including interest on investment and rezoning and assembly costs, where the sponsor has acquired the land within one year.

5. Reemphasize the need for establishment and maintenance of market data information and the need for more careful analysis of the data in approving applications.

6. Assure that field offices are provided with sufficient staffing to maintain and use up-to-date data banks in all disciplines.

FINDING NO. 4 - INDUCEMENTS NEEDED TO PROMOTE PROJECT CONTINUITY

Inducements to participate in the Section 236 program are structured to promote project construction in lieu of promoting long-term ownership. As a result, higher mortgage amounts were insured and interest assistance payments were increased.

The HUD process and Federal Income Tax Regulations are structured to encourage project construction and short-term ownership. Incentives to encourage long-term ownership and efficient management of Section 236 projects are practically nonexistent.

a. Inducements to Construct Projects

Monetary inducements to construct projects result in higher mortgage amounts which in turn increases HUD's interest assistance obligations over the 40-year mortgage life.

With regard to limited dividend projects, we found that mortgagors were monetarily encouraged into the Section 236 program (1) with the generous profit allowance legislatively permitted and called Builder's and Sponsor's Profit and Risk Allowance (BSPRA), and (2) through the application of a fiscally liberal processing attitude.

1. Builder and sponsor profit and risk allowance

In addition to allowing a 10 percent profit on construction costs, the builder/sponsor is allowed the 10 percent BSPRA on types of costs which the builder/sponsor has no interest, risk, or effort involved. The BSPRA is also allowed on the builder/sponsor's own general overhead costs.

In providing for projects developed under an arm's length arrangement between the builder and the sponsor, HUD has developed percentage guidelines to indicate reasonable amounts for builder's general overhead and profit. Under HUD guidelines (FHA Manual 72705.3(4)) dated July 1969, a non-identity of interest builder could generally expect to receive about 6.75 percent of direct job costs for general overhead and profit. However, under an identity of interest arrangement, the builder/sponsor can expect to receive about 12.3 percent for general overhead and profit.

Forty-four limited dividend projects were included in our review with estimated total development costs, excluding land, of about $88 million. Because these projects were developed under a builder/sponsor identity of interest arrangement, BSPRA of about $8.8 million was approved. Under a non-identity of interest arrangement, the builders could have expected to receive about $4.8 million for general overhead and profit or about $4 million less than allowed. Therefore, about 4½ percent of each limited dividend mortgage is made available to induce project construction.

2. Liberal processing

The liberal nature of HUD staff reviews was apparent throughout the processing system. The more significant areas that have a direct effect are discussed in other sections of this report, such as land valuations, cost certification reviews, identity of interest subcontractors, and cost estimating.

We believe that knowledgeable builders/sponsors are well aware of the resources and the attitudes of HUD processing staffs. Further, as an astute businessman, the builder/sponsor is prepared to use the knowledge to his own full advantage.

b. Incentives to Own and Operate Projects

Two principal methods of financial reward are available to limited distribution mortgagors: (1) an annual return of 6 percent of the initial equity investment, if available in surplus; (2) special Federal income tax shelter benefits.

1. Annual dividend

Limited distribution mortgagors may be paid annual dividends from project surplus, in amounts equal to 6 percent of the initial equity investment in the project. The right to a dividend is cumulative, therefore, amounts not received each year may be carried forward until sufficient funds are available in surplus for payment. Thus, a mortgagor of a successful project could receive $6,000 annually for each $100,000 initially invested.

The Wall Street Journal of November 24, 1971, quoted the following yield rates on Government securities:

Description	Maturity	Percentage Yield
Treasury Bonds	5 years	5.28
U.S. Treasury Notes	"	5.58
Federal Home Loan Bank	"	5.65
Federal Land Bank	"	5.81
U.S. Treasury Bills	90 days	4.46

As illustrated above, there was little difference between the maximum allowable yield on the 40-year investment and the yield available on relatively short-term "no-risk" investments. Consequently, we believe that the allowable limited dividend is too restrictive and serves as a deterrent to prudent investors.

2. Federal income tax advantage

The Federal income tax "shelter" through accelerated depreciation which is available to Section 236 mortgagors is real and substantial. However, the

tax benefits are substantially exhausted within a ten-year period. Consequently, the tax shelter benefits offer little, if any, incentive to long-term ownership and sound management. To the contrary, the available tax shelter benefits tend to promote construction and short-term ownership as opposed to long-term investment and ownership.

As stated above, except for income tax benefits, Section 236 program inducements encourage the builder/sponsor to construct projects. Further, the resulting costs end up in the insured and subsidized mortgage amount thereby substantially increasing HUD's interest assistance obligations.

In our opinion, the existing inducement-to-builder system places undue emphasis on the production end of the process and de-emphasizes the management aspect of 236 projects. We believe that by reducing construction oriented benefits and increasing management oriented benefits long-term investor/owners could be attracted into the Section 236 program. For example, through the elimination of the BSPRA, builder's profit could be restructured to a normal and customary amount and mortgage amounts could be significantly reduced. The resultant savings could be used to increase the limited return on investment --- say from 6 to 10 percent or more. In this manner, inducement costs would be paid from project revenues rather than from mortgage proceeds, and improved management encouraged.

Recommendation

We recommend that the Assistant Secretary, Housing Production and Mortgage Credit, initiate action to (1) either eliminate or substantially reduce the BSPRA allowance and (2) apply the resultant project development cost savings in a manner that will encourage long-term and efficient project management.

FINDING NO. 5 - SECTION 236 FUNDS USED FOR HOUSING COLLEGE STUDENTS

In lieu of utilizing Title IV of the Housing Act (College Housing), certain projects were insured under Section 236 for the primary purpose of providing housing for college students. As a result, HUD has incurred an additional potential expense of about $6.7 million.

Four of the 62 projects included in our test were developed for the principal purpose of providing housing for married college students at the following locations:

Location	Mortgage Amount	Interest Rate	Number of Units
Sacramento, Calif.	$1,473,800	8	125
Ellensburg, Wash.	1,258,500	8½	92
San Antonio, Tex.	2,812,400	7½	200
Edmund, Okla.	1,116,300	7½	82
TOTAL MORTGAGE AMOUNT	$6,661,000		

The Government's maximum interest assistance obligation over the 40-year mortgage life is about $12.7 million, computed as follows:

Subsidized[1/] Interest (Rate)	40-Year Cost per $1,000	Mortgage	Maximum Subsidy (Millions)
7	$1,985.60	1,473,800	$ 2.926
7½	2,163.20	1,258,500	2.722
6½	1,812.80	2,812,400	5.098
6½	1,812.80	1,116,300	2.023
		Total	$12.769

1/ Actual mortgage interest rate less 1 percent

The Housing and Urban Development Act, as amended, includes under Title IV, authorization for Federal assistance to colleges and universities for the specific purpose of providing housing for students and faculty. As it relates to housing, Title IV essentially authorizes HUD to subsidize the difference between actual interest costs and [illegible] percent.

Due to the tax exempt status of bonds issued by many colleges and universities, the average interest rate to colleges and universities is somewhat lower than on HUD insured mortgages. Accordingly, we have liberally estimated the average annual interest rate to be 6½ percent. Considering the 6½ percent rate, we estimate that, had the four projects been developed under the College Housing Program, HUD's maximum potential interest subsidy expense would have been about $5.9 million, or about $6.7 million less than the Section 236 expense.

The college housing nature of the projects can be illustrated as follows:

> Both the feasibility and firm Application-Project Mortgage Insurance (FHA Form 2013) identify this project as "Campus Gardens (married student housing)." Furthermore, HUD internal processing correspondence clearly evidences that marketability approval was based on the college student market. For example, in a memorandum to the Chief Appraiser dated April 15, 1969, evaluating the application, the Multifamily Appraiser included the following comments and conclusions:
>
> > "...Occupancy in the immediate area, which caters to students, ... has been excellent, although vacancy increases in summer. The best indicator of occupancy for married student housing is College Town, which is now 100% occupied with a waiting list of 118."

"Conclusions

1. That there is a present and increasing need for married student housing.

2. That the site is well situated to serve this need.

3. That the basic rents developed are below the market,...

4. That a proposal along these lines will meet with success."

While not specifically required by HUD regulations, we found no evidence in the HUD files to indicate that the four projects listed above were considered for rejection under Section 236 and resubmission under the College Housing Program. We concluded that the projects were processed under Section 236 simply because a student market existed and existing regulations do not prohibit the use of Section 236 funds to meet the market.

Notwithstanding the absence of legislative prohibition, we believe it is fiscally imprudent to use the more expensive Section 236 program to satisfy a market need that can be met by less expensive means.

The Assistant Secretary for Housing Production and Mortgage Credit advised that it has never been the policy of the Department to promote the development of Section 236 housing for college students and that field offices have been discouraged from using the program for such purposes. He also advised that a new Section 236 Handbook, currently in clearance, indicates that Section 236 is not designed to serve as a housing resource for college students and that the project selection criteria will work to assure that the greatest unmet needs for housing will receive funding priority.

Recommendation

We recommend that the Assistant Secretary, Housing Production and Mortgage Credit, revise the new Handbook to establish a policy to effectively prohibit the acceptance for processing under Section 236 of projects proposed specifically to meet a college-student housing need; such applications should be returned for possible resubmission under the College Housing Program.

FINDING NO. 6 - ESTABLISH MINIMUM INCOME LIMITS AND STRENGTHEN VERIFICATION OF TENANT INCOME

Because minimum income limits have not been established for initial occupancy, a significant number of tenants were permitted to initially occupy Section 236 projects even though their rent payments were well above 25 percent of their reported annual gross income. As a further result, tenants with high rental payments in relation to their income may be unable to pay monthly rents, particularly in times of financial stress.

Our review of tenant files at 62 projects comprising about 9,450 units showed that 29 percent (2,759) of the families (excluding rent supplement tenants) admitted to assisted occupancy had disclosed gross incomes which would qualify them for admission to low-rent public housing. Aside from the unduly heavy financial burden placed on these families, the questionable ability of such a significant number of tenants to pay the basic rent without additional subsidy will further jeopardize the economic soundness of the projects. In addition, the validity of the tenant income verification process is open to serious question in view of the very low income reported for some families.

Tenants admitted to assisted occupancy in projects insured under Section 236 generally must have incomes not in excess of 135 percent of the maximum income limits that could be established in the area for initial occupancy in public housing dwellings (termed regular income limits). Tenants whose incomes exceed these limits but do not exceed 90 percent of the income limits for occupancy in Section 221(d)(3) BMIR projects (termed exception income limits) could be housed in Section 236 projects; however, these higher income limits are restricted to 20 percent of the authorized funds available for the

program. Congressional Committee reports indicate that families with incomes in the general range of $3,000 to $7,000 will be eligible to participate in the 236 program.[1]

In addition to these limitations on tenant occupancy contained in the Housing and Urban Development Act of 1968, the Department is required to use authorized funds so as to accord preference to those families whose incomes are within the lowest practicable limits. The Act also provides for the establishment for each dwelling unit a basic rental charge determined under a 1 percent mortgage and a fair market rental charge determined under the actual mortgage covering the project. Further, the Act provides that the rental paid by the tenant shall be at the basic rental charge or such greater amount, not exceeding the fair market rental charge, as represents 25 percent of the tenant's income. Therefore, we believe the lowest practicable income limit intended by the Act for most tenants is a family income from which the basic rental could be paid with no more than 25 percent of the family income.

a. Percent of Income Paid for Rent

Based on information for the 2,759 families with very low incomes admitted to assisted occupancy in the projects included in our review, the percent of average annual gross income paid in rental charges was as follows:

1/ Certain statistical data obtained during our review on project composition and tenant characteristics is presented in Exhibit 2. The statistics on the 62 projects we examined were consistent with similar information contained in the report issued in mid-April 1971 by the Deputy Under Secretary's office.

No. of Families	No. in Family	Annual Average Basic Rent 1/	Average Annual Gross Income	Percentage of Income Paid For Rent
284	1	$1,068	$2,173	49.14
715	2	1,212	3,020	40.13
840	3	1,428	3,530	40.45
409	4	1,428	3,639	39.24
262	5	1,584	3,937	40.23
129	6	1,584	4,215	37.58
120	7 or more	1,716	4,325	39.67
2,759				

1/ Based on HUD suggested minimum occupancy.

Preliminary data compiled by the Housing Management Program Statistics Division covering about 18,000 families at March 31, 1971, showed a similar percentage distribution of families with very low income in Section 236 projects.

In our opinion, the admission of such a large number of tenants who must pay such a high percentage of their incomes for rent, could seriously impair the financial condition of the projects through rent payment delinquencies.

The full impact of the financial burden on the tenants not aided by rent supplements becomes more apparent when equated to the plight of a four-member family that pays $1,428 for rent from an annual gross income of $3,639 and must meet all their living expenses except housing with only $2,211 ($184 per month or $42 per week). Obviously, tenants in such financial straits must receive additional help, either from some form of subsidy or from other income or

funds not included in the certification and verification process, or their tenure in the project will be terminated, probably by eviction.

The additional use of rent supplements may be a partial solution; however, even if sufficient rent supplement authority were available to aid all qualified tenants, there are many communities that have not given the necessary local approval so the rent supplement program can be used. We also noted some instances where mortgagors knew rent supplement funds were available but declined or failed to apply for the subsidy.

In our opinion, most of these tenants may eventually be evicted for nonpayment of rent resulting in a high turnover rate, causing additional expense, leading to a more expensive project operation and ultimately to higher rental charges. Although the counsel and instructions provided in the recently issued Management Guide (RM G 4351.1, Management of HUD-Insured Multifamily Projects Under Section 221(d)(3) and Section 236 - July 1971) should be of major help to mortgagors, we believe more definitive guides or specific limitations will be necessary in order to obtain a healthier economic mix of tenants who occupy subsidized projects.

b. Income Verification

The responsibility for verification of tenant's income is placed with the mortgagor by Paragraph 26, Handbook FHA 4442.1, Rental Housing for Lower Income Families (Section 236).

In many instances, the tenants' gross income included in the averages shown in the preceding tabulation was so low as to raise serious questions on the

validity of the income verification process. For example, the records for one project in Pontiac, Michigan, showed very low incomes for one-third of the tenants (51 of 151), including the following extremely low incomes:

Unadjusted Annual Income	Rental Charge Paid By Tenant	Percentage of Rental Charge To Income
$1,872	$1,285	68.6
2,316	1,521	65.7
2,088	1,285	61.5
2,486	1,521	61.2
2,520	1,521	60.4

The records for three of the above tenants contained no evidence of income verification; further, some mortgagors or their agents seemed to give little thought during initial rent up as to how such low income tenants could pay other living expenses. Based on our observations and discussions with mortgagors or their agents, we believe there is a general attitude of laxity in carrying out the verification of tenant's income. As a further indication of this laxity, we found no written evidence of verification for about 15 percent of the tenants in 20 of the first 35 projects included in our review. In our opinion, greater attention by HUD field office personnel is necessary to counteract this attitude of laxity and strengthen the income verification process.

Recommendations

To promote a more stable tenant body capable of continued support of the necessary rent schedule of a project and to strengthen the tenant income verification process, we recommend that the Assistant Secretary, Housing Management, develop and implement written policy to:

1. Establish a specific percent of rental charges to income to serve as an economic floor for admission to assisted occupancy thereby establishing a minimum income limit for tenant eligibility. Authorize the field office directors to waive the minimum income limitation so established under specific circumstances such as the demonstrated ability of the tenant to pay comparable rents.

2. Review in detail with the mortgagor and/or its management agent the essential steps in carrying out the verification of tenant's income before the initial occupancy of the projects. Establish a schedule to review the mortgagor's verification efforts, including independent confirmation where warranted, on a sample basis at least once during the normal certification period.

(We were advised by the Assistant Secretary for Housing Management at the conclusion of our audit that policy determinations and revised procedures which are in consonance with the above recommendations are either in preparation or in process of clearance for publication.)

FINDING NO. 7 - NEED TO STRENGTHEN ELIGIBILITY CRITERIA FOR NONPROFIT MORTGAGORS

A significant percentage of nonprofit projects have gone into default. We believe one of the principal causes of such defaults is the fact that HUD does not require equity investment by nonprofit sponsors and does not impose minimum asset requirements.

HUD policy pertaining to the eligibility of nonprofit sponsors and mortgagors is expressed in Handbook FHA 4442.1. Essentially, the only prerequisite to nonprofit eligibility is that the sponsor and mortgagor be organized for purposes other than making a profit and not be controlled by anyone seeking to profit from its existence. No eligibility requirements exist that in any way give HUD assurance that a proposed mortgagor nonprofit organization is financially sound, will have continuity of life, or will in fact financially assist the project in times of financial stress.

To the contrary, nonprofit mortgagors have been encouraged and assisted into the 236 program even though the nonprofit entity may not possess any of the desired characteristics needed to lend assurance that a viable project will result. For example, in our test projects, we found most nonprofit mortgagors were newly created organizations "spun-off" from established organizations for the sole purpose of developing the project. Consequently, the mortgagor organization was (1) almost totally devoid of assets; (2) a new organization in the community and, therefore, had no established membership or other means available as a reliable source of additional funds; and (3) totally separate and apart from the originating entity (generally the sponsor); therefore, the originating entity was not

financially responsible to the project. Further, because existing policy permits the development of 236 project with no equity investment, the insured mortgage amounts represent the total actual development cost plus a working capital allowance of up to 2 percent.

We learned that nonprofit 236 projects were generally conceived and promoted by either (1) a builder who aspires to profit on the proposed project site, profit resulting from project construction, or both; or (2) a housing consultant motivated by the substantial fee involved. For 16 nonprofit projects included in our review we found that the builder had an interest in the project land in seven cases and housing consultants were employed in connection with six additional projects; thus about 81 percent of the nonprofit projects we examined could have been motivated primarily by profit considerations.

As discussed above, nonprofit mortgagors are usually "spun-off" from established nonprofit organizations. The following example illustrates the basic practice:

Project A, Sacramento Insuring Office

This project consisted of 175 units of three, four, and five-bedroom apartments. The nonprofit sponsor, although weak financially and in housing experience, had existed for about six years for the purpose of assisting Spanish speaking groups to consolidate their efforts toward overcoming social problems of the Mexican-American ethnic group. Utlimately, the mortgagor corporation was created on August 11, 1969, just two days before initial endorsement.

Soon after project completion, the project began experiencing financial difficulties. Since neither the sponsor nor the mortgagor had financial strength, the project was in process of foreclosure at the time of our visit in September 1971.

We believe that the possibility of foreclosure on the above project could have been avoided had HUD required the mortgagor to:

1. Financially participate in the project.
2. Have been established in the locality for a reasonable period of time.
3. Have demonstrated a minimum net worth.

Based upon our audit test about 26 percent of Section 236 projects (16 of 62) had nonprofit mortgagors. At September 30, 1971, however, 73 percent of all the Section 236 projects reported in default (24 of 34 projects) had nonprofit mortgagors. In our opinion, the disproportionate percentage of nonprofit defaults was directly attributable to the absence of sound nonprofit mortgagor eligibility criteria.

Recommendations

We recommend that the Assistant Secretary, Housing Production and Mortgage Credit, institute action to effectively strengthen the existing nonprofit mortgagor eligibility criteria. As a minimum, consideration should be given to:

1. Requiring the mortgagor to furnish the necessary working capital from other than mortgage proceeds by discontinuing the Allowance to Make Project Operational (AMPO).

2. Establishing minimum mortgagor asset requirements.

FINDING NO. 8 - UNDESIRABLE SITE LOCATIONS

In our inspections of 62 Section 236 projects, we observed 24 projects with undesirable site characteristics or locations; some projects had one or more such type problems. We found four site locations that possessed serious topographical or subsidence problems which may result in hazardous conditions, poor drainage and potentially costly maintenance. We noted that five sites were near or contiguous to undesirable industry; five new projects were located in areas that further impact minority and/or low-income concentrations; and 16 projects that were situated on sites in outlying areas remote from shopping and social services.

a. Topography and Subsidence

Four of the sites visited were in areas of inherent subsidence or topographically unsuitable for development.

Section 72905.4 of Book 2, Volume VII, of the FHA Manual indicates that sites with hazards relative to topography and/or subsidence should not be approved for mortgage insurance if the conditions are serious and impossible to overcome.

Three of the Section 236 sites visited (one each at San Diego, Atlanta, and Naugatuck, Connecticut) were constructed in topographically unfit areas with extremely severe terrain, unstable slopes and ravines, soil erosion and drainage problems resulting in hazardous conditions. As a result, operating funds will need to be expended for land development and repairs relative to the site topography.

Another project at Dallas, Texas was developed on an old lake bed at relatively high unit cost for land and development. This 1½-year old project had serious subsidence problems at the date of our inspection in company of a HUD architect in August 1971. Substantial sums will be required to repair the damages resulting from subsidence.

b. Industrial Neighborhoods

We did not find Section 236 projects near offensive industry as a wide-spread problem. However, we noted five sites that, in our opinion, should have been rejected because they did not meet the requirements of HUD regulations and policy. In Atlantic City, New Jersey, one site was adjacent to a junkyard and other light industry. In San Antonio, Texas, we found a project developed immediately adjacent to an unsightly, rubble-strewn creek, which was the only barrier between the site and an auto wrecking yard. One project in Michigan was contiguous to an unfenced railroad track on one side and an auto wrecking plant on the other; another project in Michigan in a rural setting was contiguous to a major high-tension power line as well as a railroad track. One project in Indiana was adjacent to large power transmission towers and lines in a rural setting where most of the surrounding area was vacant.

c. Impacting

Our review showed that five new Section 236 projects visited (excluding five inner city rehab projects) were located in recognized minority areas with the projects having similar or greater minority ratios. Some of these projects

were located adjacent to or in the immediate vicinity of two or more other low-income and/or subsidized housing projects in existence, planned, or under construction.

While we recognize there have been no instructions prohibiting projects in impacted areas, in our opinion, the concentration of low-income and subsidized housing, expecially in established minority areas, circumvents, in part, the intent of Federally-assisted housing.

d. Remote Sites

Sixteen of the 62 sites that we visited were located in outlying or rural settings, that were one to three miles distant from public transportation, essential shopping areas, and other community facilities. Tenants in these projects were not adequately served by convenient shopping and social services, and must incur extra expense for transportation costs. Other negative effects influencing project occupants include the following:

1. Goods and services necessary for daily living were not readily available.

2. Automobile ownership was mandatory for seeking and maintaining employment, with further need for a second car for daily social and shopping requirements. Acquisition of a second car negates rent savings from the subsidy.

3. Children did not have community centers, library services, parks and playgrounds, or other community facilities readily available for activity, growth, and cultural influences.

4. Social services, such as legal, medical, and other professional services required for low-income families, elderly, and infirm were remote or otherwise not readily available.

Existing HUD policies indicate the following as major considerations governing acceptance of multifamily project sites for insurance:

1. Convenient transportation to places of employment, major shopping districts, and civic and social centers is a prerequisite to project location acceptability.

2. A location for a multifamily project must be adequately served by schools, neighborhood shopping centers, churches, playgrounds, parks, libraries, hospitals, and theaters.

The FHA Manual, Volume VII, Book 2, 72905.4, provides that a location will not be rejected for the absence of convenient schools, shopping centers, transportation, etc., <u>unless</u> there are more suitable alternative sites or locations available for the same market. Our reviews of the processing activities related to the 16 projects in remote locations did not disclose any evidence indicating that consideration was given to obtaining more suitable alternative sites for the projects.

In our opinion, sites with topographical or subsidence problems and offensive industrial area sites may not have been approved if established policies and procedures had been judiciously followed. We believe that the policies and procedures were not carefully considered because of the emphasis placed on the production of housing to meet the urgent needs. As a result, in many cases, poor or otherwise unsuitable site locations were approved. Although the urgent need for housing remains, the demand for producing the necessary housing has increased as shown by the volume of subsidized housing produced, in the pipeline, and in the application processing stages. Consequently, it is imperative that greater care and selectivity be used in approving site locations in future applications for mortgage insurance.

Recommendations

Because of the lower income status of tenants in Section 236 projects and their special needs for greater reliance on public transportation and convenient accessibility to necessary goods and services, we recommend that the Assistant Secretary for Housing Production and Mortgage Credit issue instructions to require field offices to exercise greater care and selectivity in approving project site locations and to reject for mortgage insurance those sites that are situated in remote locations, industrial neighborhoods, or possess unusual topographical hazards or conditions.

We believe effective implementation of new Project Selection Criteria, which will become effective on February 7, 1972, can provide the means for eliminating most of the problems relating to undesirable site locations on future project applications.

FINDING NO. 9 - PROVIDE FOR CANCELLING PROJECTS PRIOR TO FIRM COMMITMENT

Because HUD considers its feasibility determination to be somewhat absolute and not subject to renegotiation or cancellation, unmarketable projects were insured.

HUD's policy with regard to feasibility determinations is included in the FHA Manual, Volume VII, Book 2, Paragraphs 72427.10 and 72428.1b. As stated and applied, HUD's policy is:

> "Key decisions concerning project feasibility, including the location, land value, project size and type, rentals, expenses, project cost estimate, construction budget, tentative mortgage amount, expected cash requirements, and sponsor acceptability are made by the Multifamily Coordinator at the Feasibility Stage of processing. It is anticipated that feasibility determinations will remain firm. Once determined at the Feasibility Stage, they will not be subject to further FHA review, except as made necessary by sponsor actions."

We believe HUD's policy is unduly inflexible and may not be in the public interest as illustrated below.

In the Seattle-Everett-Tacoma, Washington, Housing Market Area (HMA) the apartment rental market began softening in late 1968. The rental market continued to deteriorate and by February 1970 had reached an apartment vacancy percentage of about 22 percent. Notwithstanding the soft market conditions, HUD continued to honor feasibility letters and conditional commitments issued both prior to and during the softening market period. For example, 417 elderly units that had been determined feasible prior to the soft market period were authorized for construction after HUD became aware of the serious over-supply of units in the HMA. Our review of field office files and discussions with the field office Director and other key officials

indicate construction was authorized because "...it was felt that the moral commitment to proceed was greater than our justification to cancel these developments."

At August 31, 1971, 21 subsidized projects located in the Seattle-Everett-Tacoma HMA were in various stages of default. The 21 projects had a total of 1,954 units, were experiencing about 38 percent vacancy, and involved insured mortgage amounts totalling about $27 million. We believe the high vacancy percentage points to the soft market as being the principal cause of defaults.

In our opinion, economic and market feasibility must be the prime consideration for project approval. Further, the economic and market feasibility aspect of project evaluation must be continual. Localized changes that might affect project viability must be continually evaluated, at least to firm commitment.[1/]

Recommendations

To preclude insuring projects that do not provide reasonable assurance of success, we recommend that the Assistant Secretary, Housing Production and Mortgage Credit, modify existing policy to require:

1. Continued project evaluation to the time of firm commitment.

2. Commitment cancellation when the test of economic and market feasibility cannot be met at any processing point prior to firm commitment.

3. The pro forma "feasibility letter" to clearly inform the Sponsor/Mortgagor to the effect that the feasibility determination is subject to revocation at HUD's discretion.

1/ See page 48 for discussion of similar localized conditions affecting marketability of projects in the pipeline which merit further evaluation.

EXHIBIT 1

REPRESENTATIVE TENANT ELIGIBILITY FINDINGS

We reviewed the mortgagors' files and records, as well as the field office monitoring activities, pertaining to the selected 62 Section 236 projects to determine the degree of adherence to certain HUD requirements applicable to operation of the projects, including requirements concerning tenant eligibility and rental rates. Following are representative findings disclosed during the review and included in the individual reports for each project:

1. Over-income tenants erroneously admitted to assisted occupancy, under one-year leases, thereby possibly causing large monetary loss to HUD.
2. Tenants not required to certify family income and composition on FHA Form 3131, "Application for Tenant Eligibility Under the Section 236 Program."
3. Tenants' income not verified or insufficiently verified.
4. Rental units under-occupied and over-occupied.
5. Insufficient rents collected from tenants eligible for assisted occupancy.
6. Rents collected in excess of basic rents not remitted to HUD.
7. Improper or unexecuted leases.
8. Improper charges to tenants for electricity, security deposits, etc.
9. Tenants' security deposits not held in a separate trust account.
10. Project funds commingled.
11. Rent supplement overpayments.
12. Inadequate mortgage servicing or monitoring of project activities by field offices.

STATISTICAL SUMMARY ON PROJECT COMPOSITION AND TENANT CHARACTERISTICS IN PROJECTS EXAMINED

Project Composition

Number of Bedrooms	Number of Units	Percent
0-BR	31	.33
1	2,051	21.71
2	4,444	47.05
3	2,380	25.20
4	487	5.16
5	52	.55
	9,445	100.00

Tenant Characteristics

Family Composition

Number in Family	Percentage of Families in Project
1	12.13
2	25.10
3	29.71
4	16.33
5	9.40
6	4.25
7 or more	3.08
	100.00

Age of Head of Household

Age	Percent
Under 21	10.10
21-29	54.41
30-39	16.24
40-49	6.72
50-64	5.76
65 and over	6.77
	100.00

Sex of Head of Household	Percent
Male	63.62
Female	36.38
	100.00
Approved Income Limits for Initial Occupancy	
Regular	88.69
Exception	11.31
	100.00
Distribution of Rental Charges Paid	
Basic Rental	85.05
More than Basic but Less than Market	13.41
Market	1.54
	100.00
Number of Families on Welfare	15.50
Female Head of Household with Minor Children	26.81

DISTRIBUTION

Secretary
Under Secretary
Special Assistant to the
  Under Secretary (Mr. Richard Goldstein)
Assistant Deputy Under Secretary
Assistant Secretary for Housing Production
  and Mortgage Credit
Assistant Commissioner for Administration, HPMC
Assistant Secretary for Housing Management
Director, Office of Administration and Local
  Agency Services, HM
Assistant Secretary for Administration
Director, Office of Budget
Director, Office of Management and Organization
Acting Director, Office of Investigation
General Accounting Office
Regional Administrators
Area Office Directors
Insuring Office Directors