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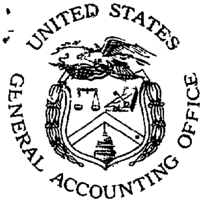

REPORT TO THE CONGRESS

Questions Regarding Mortgage Loan Insurance Ceilings And Land Appraisals For Large Cooperative Housing Communities

B-158910

Department of Housing and Urban Development

BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

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FEB 27, 1970

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D C 20548

B-158910

To the President of the Senate and the
Speaker of the House of Representatives

This is our report on questions regarding mortgage loan insurance ceilings and land appraisals for large cooperative housing communities, Department of Housing and Urban Development

Our review was made pursuant to the Budget and Accounting Act, 1921 (31 U S C. 53), and the Accounting and Auditing Act of 1950 (31 U S C. 67)

Copies of this report are also being sent to the Director, Bureau of the Budget, and to the Secretary of Housing and Urban Development.

Elmer B. Staats

Comptroller General
of the United States

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ABBREVIATIONS

FHA Federal Housing Administration

GAO General Accounting Office

HUD Department of Housing and Urban Development

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

QUESTIONS REGARDING MORTGAGE LOAN INSURANCE CEILINGS AND LAND APPRAISALS FOR LARGE COOPERATIVE HOUSING COMMUNITIES
Department of Housing and Urban Development
B-158910

D I G E S T

WHY THE REVIEW WAS MADE

The Department of Housing and Urban Development (HUD) is authorized to insure mortgages for cooperative housing projects At March 31, 1969, HUD had insured or had commitments to insure mortgages of about $800 million for management-type cooperatives Of this amount, about one third (approximately $270 million) represented mortgages applicable to one completed and four partially completed Rossmoor Leisure World developments. (See p. 6.) As of March 1969 no other cooperative housing communities of such size and complexity had been, or were being, financed by HUD-insured mortgage loans.

The General Accounting Office (GAO) reviewed certain statutory provisions and HUD's procedures and practices for insuring mortgage loans for large cooperative communities. Although GAO's report discusses HUD's involvement with the financing of Rossmoor Leisure World developments, the basic questions raised would be pertinent to any large communities of this type that may be built in the future

FINDINGS AND CONCLUSIONS

This report raises questions regarding mortgage loan insurance ceilings and land appraisals. These questions stem primarily from HUD's practice of insuring mortgage loans for large and complex cooperative housing communities under legislative provisions and related administrative procedures which, we believe, were geared to provide Federal assistance for smaller, less complex projects.

Each Leisure World community involves a number of cooperative mortgagor corporations which are formed in succession as sales and construction of segments of the overall planned community progress. Each corporation owns one or more property segments of the planned community and is responsible for the mortgage loans covering those segments. (See p. 9.)

Although segments of the Leisure World communities are mortgaged separately, they are closely related to each other. They have been planned and developed by one sponsor as interdependent and integral

parts of a large, self-contained community. The residents share in the ownership, use, and maintenance of community improvements as well as a variety of recreational and educational facilities. (See p. 11.)

The statute authorizing HUD's assistance provides that the amount of an insured mortgage on any property of a private mortgagor, such as Leisure World, cannot exceed $20 million. HUD applied the $20 million statutory limit to each segment of a Leisure World community. As a result there is no limit on the aggregate amount of mortgage loan insurance risk the Federal Government can assume on such a community.

The amount of all insured mortgages covering the one completed Leisure World community is about $75 million, and it was originally planned that the four partially completed communities would have insured mortgages of from $250 million to $375 million each. (See p. 9.)

GAO believes that HUD's application of the statutory mortgage limitation to individual segments of one large development may not have been envisioned by the Congress when the mortgage limitation was established in 1950 or when the Congress explained in 1955 how the limitation was to be applied to rental-type projects. (See p. 11.)

HUD's treatment of each segment of a development as a separate project resulted in substantial increases in land appraisals. Under normal procedures for determining the amount of an insured mortgage loan for a multifamily housing project, HUD estimates the fair market value of the land at the time the commitment to insure the mortgage loan is issued. This is generally prior to the beginning of construction of the project. (See p 20.)

In the case of Leisure World communities, HUD made a separate appraisal of the land in each of the individual segments of the planned community. These appraisals were made over a period of years and included increases in land values created by the publicity for the planned community and by the construction progress of the community. (See p. 20.)

HUD's records showed that its appraisal amounts, substantially exceeding the developer's purchase price, generally became the land prices paid to the developer by the cooperative mortgage corporations. Available information did not show the extent to which the total increases in land appraisal values were attributable to the publicity and construction progress of the Leisure World communities. (See pp. 21 and 22.)

Legislative history indicated to GAO that the principal objective of the cooperative housing mortgage insurance program was to assist in providing housing at reduced costs to the consumers and that the program was to be administered to ensure that its benefits would accrue to the consumers (See pp. 24 and 25.)

RECOMMENDATIONS OR SUGGESTIONS

The primary purpose of this report is to focus congressional attention on the questions raised in GAO's review.

AGENCY ACTIONS AND UNRESOLVED ISSUES

HUD and the Leisure World builder generally expressed the view that HUD's application of the mortgage limitation and HUD's land appraisal procedures and practices were appropriate for insured mortgage loans for communities such as those discussed in this report. (See ch. 3 and apps. I and II.) GAO believes that, in view of the nature and magnitude of these communities and the basic intent of the cooperative housing mortgage insurance program, the questions raised by GAO concerning the mortgage limitation and land appraisals warrant congressional attention.

MATTERS FOR CONSIDERATION BY THE CONGRESS

The Congress may wish to consider whether statutory provisions and HUD procedures relating to mortgage loan insurance ceilings and land appraisals are appropriate for large and complex self-contained cooperative housing communities of the type discussed in this report

CHAPTER 1

INTRODUCTION

The General Accounting Office has made a review of the application and appropriateness of certain mortgage insurance underwriting requirements established by law and related administrative procedures and practices of the Federal Housing Administration (FHA), Department of Housing and Urban Development, relating to the approval of mortgage insurance, under section 213 of the National Housing Act (12 U.S.C. 1715e), for large and complex cooperative housing communities such as the Rossmoor Leisure World developments. The scope of our review is presented on page 35 of this report.

FHA was created in 1934 under authority granted by the National Housing Act (12 U.S.C. 1702) and is presently a part of HUD. The National Housing Act, as amended, authorizes FHA to administer a number of programs under which lending institutions are insured against losses on mortgage loans for individual homes and multifamily housing projects.

FHA is headed by an Assistant Secretary-Commissioner who has overall responsibility for mortgage insurance activities. The headquarters office in Washington, D.C., establishes policies, procedures, and program requirements; and regional insuring office directors are responsible for FHA operations within their respective jurisdictions. The principal HUD officials responsible for the administration of the activities discussed in this report are listed in an appendix to this report.

Section 213, added to the National Housing Act in April 1950, was the first major legislation providing a specific program for FHA insurance of mortgage loans on cooperatively owned housing. The legislative history of section 213 indicated to us that this section was generally intended to assist in providing housing at reduced costs for middle-income families who were not being served under other sections of the act.

Section 213, as amended, authorizes FHA to insure mortgage loans under three basic cooperative housing programs. The projects financed under these three programs are referred to as:

1. <u>Management-type cooperatives</u>--usually consisting of multifamily elevator or garden-type apartments owned, occupied, and managed by members of a nonprofit cooperative corporation, which is the mortgagor from the inception of the project.

2. <u>Investor-sponsor projects</u>--usually consisting of multifamily elevator or garden-type apartments built by a profit-motivated sponsor (acting as mortgagor during the construction stage), which has certified that it intends to sell the project to an acceptable management-type cooperative within two years after completion.

3. <u>Sales-type cooperatives</u>--consisting of five or more single-family homes constructed for a nonprofit cooperative mortgagor corporation under one insured mortgage but, upon completion of the project, homes are individually owned by members of the corporation under separate insured mortgages.

The Leisure World developments are financed by mortgages insured under the program for management-type cooperatives.

Under the law the amount of an insured mortgage for a section 213 management-type cooperative project owned by a private (as distinguished from public) mortgagor cannot exceed $20 million. In addition, the law requires that an insured mortgage loan for a section 213 management-type cooperative project cannot exceed the lower of (1) 97 percent of FHA's estimate of the cost of the proposed project, which includes an estimate of the fair market value of the land, or (2) an amount based on specified dollar limitations per family unit. The maximum amount of an insurable mortgage loan is determined prior to the construction of the project and, pursuant to a requirement in the law, is subject to reduction based on the actual cost to develop and construct the project as certified by the mortgagor.

The Rossmoor Leisure World developments are planned communities for adults, consisting primarily of one- and two-bedroom garden-type dwelling units and various community facilities. The basic concept is to provide (for an initial investment and a monthly charge) for occupancy of a cooperative apartment unit and its exterior maintenance and upkeep and for the use of a wide variety of recreational facilities and other benefits. There are five such developments--one has been completed at Seal Beach, California, and four have been partially completed at Laguna Hills and Walnut Creek, California; Norbeck, Maryland; and Monroe Township, New Jersey.

At March 31, 1969, FHA had insured or had commitments to insure project mortgages totaling about $800 million for section 213 management-type cooperatives. Of this amount, about $270 million represented mortgages applicable to Rossmoor Leisure World developments. As of March 1969 no other cooperative housing communities of the size and nature of the Rossmoor Leisure World developments had been, or were being, financed by HUD-insured mortgage loans.

CHAPTER 2

INSURANCE OF MORTGAGE LOANS FOR LARGE COOPERATIVE HOUSING COMMUNITIES

Our review has raised questions regarding certain matters which, we believe, resulted primarily from HUD's insurance of mortgage loans for very large and complex cooperative housing communities under legislative provisions and related administrative regulations and procedures which, in our opinion, were geared to provide Federal assistance for financing smaller, less complex projects.

Although our report discusses HUD's involvement with the financing of Rossmoor Leisure World developments, constituting about one third (approximately $270 million) of the total mortgage loans insured by HUD for management-type cooperative housing projects at March 31, 1969, our primary purpose is to focus attention on certain matters which would be pertinent to any large communities of this type that may be initiated in the future and which we believe warrant congressional attention.

Because of their very large size, each planned Leisure World community was divided into a number of segments in order to facilitate financing, sales, and construction of the community. Under its normal procedures, FHA generally requires the sale of cooperative shares or memberships covering at least 90 percent of the dwelling units in a proposed management-type cooperative project before it will insure a mortgage loan and permit construction of the project to begin. It would have been impracticable for the sponsors, before starting construction, to sell 90 percent of a total planned Leisure World community comprising many thousands of dwelling units. Further, FHA could not have provided mortgage insurance for an entire planned community as a single mortgaged property because of a provision in the law which would have limited the amount of the insured mortgage loan to $20 million.

The division of each community into a number of segments made it possible to meet the statutory mortgage

limitation and the FHA presale requirement established for management-type cooperative projects. However, such division also has the following effects:

--Although FHA can, if it so desires, discontinue its participation in the financing of a community at any time, there is no congressional or administrative limitation on the aggregate amount of mortgage loan insurance risk that FHA can assume on a self-contained community comprised of many separately mortgaged, but interdependent, property segments.

--FHA's land appraisals, which generally became the land prices paid by the cooperative consumer groups to the developer, gave recognition to increases in land values created by the overall plans for, and the publicity and progress of, the community itself.

Details on these matters are presented in the following sections.

ABSENCE OF LIMITATION ON AMOUNT OF MORTGAGE INSURANCE FOR A SELF-CONTAINED COOPERATIVE HOUSING COMMUNITY

Under the concept adopted by FHA and the sponsors, each Rossmoor Leisure World community involves a number of cooperative mortgagor corporations which are formed in succession as sales and construction of segments of the community progress. Each corporation owns one or more segments of the overall planned community and is responsible for the mortgage loans covering those segments. The mortgage loans on community segments that were completed or under way as of March 31, 1969, were insured by FHA under the provisions of section 213(a)(1) of the National Housing Act. Section 213(b)(1) of the act provides that a mortgage insured under section 213(a)(1) on any property of a private mortgagor, such as a Leisure World mortgagor corporation, cannot exceed $20 million. The limit is $25 million for a public mortgagor.

FHA has applied the $20 million statutory limitation to each segment of a Leisure World community. Accordingly, none of the numerous mortgages covering a Leisure World community individually exceeds $20 million and, in those instances where one Leisure World mortgagor corporation is responsible for more than one mortgage, the total amount of the mortgages of any one mortgagor corporation does not exceed $20 million. Under this procedure, however, the aggregate amount of FHA-insured mortgages for a total Leisure World community will substantially exceed $20 million. The aggregate amount of all insured mortgages covering the completed Leisure World development at Seal Beach, California is about $75 million--the other four partially completed Leisure World developments were originally planned to involve insured mortgages of from $250 million to $375 million each.

We believe it is reasonable to assume that the basic intent of the statutory mortgage ceiling was to place a congressional limit on the amount of mortgage insurance risk that may be assumed on any one project. With regard to the manner in which the limitation should be applied to several contiguous or adjacent projects, House Report 1622 (Conference report on S. 2126, 84th Cong. 1st sess.) on the bill

which was enacted as the Housing Amendments of 1955 stated that:

> "Subsection (c) would revise the present dollar amount limitations in the National Housing Act for FHA insured mortgages financing multifamily projects. The present $5 million limitation would be increased to $12.5 million [increased to $20 million in 1959] for projects with private sponsorship under the regular section 207 rental housing program, the section 213 cooperative housing program, the section 221 program for housing for families displaced from slum clearance or urban renewal areas or as a result of Government action, and the section 220 program for the construction or rehabilitation of housing in slum clearance or urban renewal areas. This dollar limitation is applicable only to each insured mortgage as more fully explained on pages 8, 9, and 10 of the report of the House Committee on Banking and Currency on S. 2126 with respect to section 102(b) of the bill as reported by that Committee." (Underscoring supplied.)

The explanation contained in the House report referred to in the above quotation (H. Rept. 913 on S. 2126) dealt principally with the manner of application of mortgage ceilings to large-scale rental housing projects financed under section 207 of the act and made no specific reference to cooperative housing projects financed under section 213. In that report, the House Committee on Banking and Currency stated, in part, that:

> "Until recently, the *** limitation with respect to large-scale rental housing projects developed by private enterprise corporations had been uniformly interpreted by the Federal Housing Administration as applicable to the amount of the individual mortgage. Thus, so long as each rental project developed by such a corporation was a separate project and the mortgage with respect to each such project did not exceed *** [the limitation], several such projects could be built at the same time on contiguous sites by mortgagor corporations under

common ownership. There has never been, and should not be, any objection to such procedure so long as each such contiguous project is covered by a mortgage which does not exceed the applicable dollar limitation and is a separate project which can be sold separately and managed separately. Such administration of these provisions of the act have made possible the development of many of the large-scale rental housing projects urgently needed in the larger metropolitan centers, and your committee feels very strongly that such procedure should be continued." (Underscoring supplied.)

Because the explanation by the House Committee on Banking and Currency, quoted above, was addressed primarily to contiguous rental-type projects being built in 1955 and prior years, rather than to self-contained cooperative housing communities, and in view of the Committee's stated intent that the limitation could be applied separately to contiguous projects only if each such contiguous project were a separate project that could be managed and sold separately, we believe that the Committee may not have envisioned that FHA would undertake to insure mortgage loans aggregating several times $20 million--in fact, without any limitation--for an entire self-contained cooperative housing community comprised of a number of separately mortgaged, but interdependent, property segments.

Leisure Worlds are self-contained communities comprising interdependent property segments

Although covered by separate insured mortgages, the various segments of a total Leisure World development are closely related to each other, particularly because they have been planned, as integral parts of a self-contained community, to share in the ownership, use, and maintenance of community improvements such as common streets and sidewalks and a wide variety of recreational, educational, and other types of community facilities.

Each Leisure World development is, or is planned to be, a self-contained community, surrounded by a wall, with a private security force guarding the gates. Community

facilities, existing or planned to be built within the development, include golf courses, clubhouses, riding stables, swimming pools, medical clinics, and administration buildings and are designed and planned for the sole use and benefit of the residents of the community. The estimated construction cost of the community facilities was allocated among the planned dwelling units and was included in the purchase prices paid by the cooperative consumer groups (mortgagor corporations) for their dwelling units.

The insured mortgage loan proceeds were increased to cover the allocated costs of the community facilities through FHA's increasing its appraisal of the land underlying the dwelling units by an amount equivalent to the community segment's allocated portion of the estimated total cost of all planned community facilities. Although such increases in FHA's land appraisals were based generally on community facilities and dwelling units planned for the total community, FHA generally has required that, at any point during the development stage of the community, the aggregate amount allowed for community facilities in its land appraisals for the segments completed and under way could not exceed the estimated value of community facilities actually completed and turned over to the trustee for the community residents.

Although the cost of the community facilities to the mortgagors has been financed by the proceeds from FHA-insured mortgage loans, these facilities cannot be physically divided and parceled out to the individual segments of the development and, therefore, are not a part of the collateral for the insured mortgage loans; however, the cooperative mortgagors or their successors have the right to use the facilities and the obligation to share in the cost of their maintenance and operation, under a trust arrangement, as discussed below.

The community facilities within each Leisure World development are, or will be, owned and operated by a trustee for the joint use of all residents of the individual segments of the total community. The costs incurred by the trustee in maintaining and operating the facilities are allocated among all apartment units within the community and are generally included in the monthly carrying charges

(equivalent to rent in rental projects) paid by the residents.

On the basis of our review of the agreements entered into by the cooperative mortgagor corporations, FHA, and the community facilities trustees, we do not believe that FHA, in the event that it became an owner of a segment of a community, could control the nature, extent, and cost of activities and services provided by the trustee for the community facilities. According to these agreements, FHA would automatically become a beneficiary of the trust if it became an owner and thereby would acquire not only the right to use the community facilities but also the legal obligation to pay a pro rata share of the total maintenance and management costs of the facilities.

On August 20, 1963, the director of the FHA Cooperative Housing Division requested from an FHA attorney, having particular responsibility regarding cooperative housing matters within FHA's Office of the General Counsel, advice as to whether the arrangements concerning community facilities at the Seal Beach Leisure World community should also be used at other Leisure World communities then being initiated. The FHA attorney stated, with respect to what FHA's position would be under these arrangements in the event that FHA were to become an owner of a segment of the community through foreclosure on an insured mortgage loan, that:

> "*** FHA, as owner of a project, may be subjected to pay for services it does not want in order to obtain the minimum services required, such as the upkeep of the streets owned and maintained by Golden Rain [community facilities trustee]. It should be spelled out *** that FHA or its occupants need not take all of the services of Golden Rain and that the cost of such services, which FHA or its occupants do take, should not exceed the cost collected from the cooperatives on a per occupant basis. In short, FHA occupants must be assured they will pay no more than cooperative occupants for a particular service which FHA occupants have elected to take."

In response to the FHA attorney's statement, the attorney for the Leisure World sponsor and mortgagor corporations made the following comments in a resume forwarded to the FHA Washington headquarters office in November 1963:

> "The provision *** requiring Golden Rain [community facilities trustee] to furnish the occupants of FHA or mortgagee owned projects on a 'comparable basis' the same services furnished the cooperative members was made general deliberately. It would not be practical to attempt to anticipate and prescribe for every possible situation that might arise. Also, it would seem inadvisable to give any mortgagee on foreclosure the right to pick and choose which services of Golden Rain it will or will not use. This should be left to be worked out at the time, taking into consideration the particular circumstances. FHA not only has an interest in property which it may acquire but also in the entire project as insurer of all the mortgages. It is therefore important to FHA that nothing be done to adversely effect Golden Rain's over-all operations." (Underscoring supplied.)
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> * * * * *
>
> "As hereinabove stated, it is not practicable to seek to anticipate and specifically provide for all eventualities in case of default and FHA acquisition of a particular mortgage property. It is deemed sufficient to permit FHA the use of Golden Rain's facilities and services on a comparable basis. It is reasonable to assume that Golden Rain will want FHA's business because its operation is geared to serving the total project, and to operate short of that would probably increase the per unit cost. ***" (Underscoring supplied.)

The arrangements concerning community facilities at the Leisure World developments undertaken subsequent to the Seal Beach development do not spell out that FHA or its occupants need not take all of the services of the trustees.

We believe that, even if the arrangements were altered or modified as suggested by the FHA attorney, the problems cited by the Leisure World attorney in connection with FHA's interest in the entire project, rather than just the property it may acquire, would tend to preclude FHA's selecting operations and maintenance services to suit the individual needs or financial capability of the residents of any segment of the development acquired.

We noted, regarding the mutual dependency of the various segments of a Leisure World development, that the director of the FHA Cooperative Housing Division in Washington commented in a letter to the FHA Los Angeles Insuring Office in December 1965 that each of the cooperative corporations at the Seal Beach development in California was, in the final analysis, dependent on the others for continued success.

Because Leisure World developments have been planned as self-contained communities comprising a series of property segments that are closely interrelated and interdependent, rather than a number of separate independent projects, we believe that a permanent halt in construction prior to completion or substantial completion of such a community could result in increased costs to the residents because certain costs related to the overall community would have to be spread over a smaller number of residents than planned. A halt prior to completion or substantial completion could also result in considerably fewer services and facilities than those expected by the residents of the completed units. The ultimate control over completion of the communities as planned rests in the hands of the builder, who owns all of the land needed for the communities and, so far as we could determine, is not committed to continue selling the land to the mortgagors or sponsors as construction of the communities progresses.

We believe it likely that the concept of residing in a large totally self-contained community with a wide range of community facilities and services may have been a major inducement influencing the decision of individuals to reside in a Leisure World community. We noted that, at the time FHA insured the mortgage loan for the first segment of the Leisure World community in Maryland, the overall plan

included the following community facilities which were to serve the residents of the planned 9,000 dwelling units:

Three clubhouses (two with swimming pools)
Four guard houses
Medical clinic
Maintenance and storage building
Information center
Meeting hall
Riding stables
Auditorium
Greenhouse
Parks, lake, and equestrian trails
Golf course

The plan also included a number of recreational, educational, and other types of activities and services to be provided in conjunction with the planned facilities listed above.

Construction of the planned community facilities and their conveyance to the trustee for the Maryland community depended directly upon the completion and sale of certain numbers of dwelling units. If less than the planned number of dwelling units were constructed and sold, the construction of community facilities was to be curtailed proportionately.

As of June 1969, construction at the Maryland community had been suspended since September 1967 because of slow sales. Of the originally planned 9,000 dwelling units, about 900 had been completed as of June 1969; of the originally planned community facilities, one clubhouse (with swimming pool) and one guard house had been constructed and conveyed to the community facilities trustee for the residents of the 900 completed units. Although the golf course and the administration building had also been completed, these facilities had not been conveyed to the trustee but were still owned by the builder-landowner. The administration building was to be conveyed to the community facilities trustee for the residents after about 1,300 of the 9,000 planned dwelling units were sold, while the golf course was not to be conveyed until about 7,300 dwelling units were sold.

It seems, therefore, that, unless a substantial number of additional dwelling units are sold, the community facilities trustee for the residents of the 900 dwelling units will not obtain ownership of the golf course and administration building or of any other planned community facilities. If the overall plans for the community are carried out, these facilities will be conveyed to the community facilities trustee at no additional charge to the residents of the 900 dwelling units beyond the amounts paid when they purchased their units.

Moreover, we were advised in June 1969 by an official of the sponsor-manager of the Maryland community that, if no additional units were sold, the monthly charges to the residents for operating services would have to be increased by about $15 a month for each dwelling unit in order to maintain the level of services being provided at that time. This situation developed because the monthly charges being made to the residents for operating services were not adequate to cover the full cost of such services--the difference between the monthly charges and the cost of the services (an average of $15 per unit per month) was being financed from funds generated from the sale of new dwelling units.

We were advised by the official of the sponsor-manager that, under a new development plan being considered for the Maryland community, the number of dwelling units for the total community had been reduced to about one half of the originally planned 9,000 units. We were told that no decisions had been reached as to what community facilities, in addition to the clubhouse and gatehouse previously conveyed to the community facilities trustee, would be included in the new development plan but that efforts were being made to include the golf course.

The Housing and Urban Development Act of 1965 authorized a new program providing for FHA insurance of mortgage loans to assist developers in acquiring and developing raw land for future building sites (12 U.S.C. 1749aa). The law, as amended, provides that the outstanding principal of mortgage loans for a single land development undertaking, as defined by FHA, shall at no time exceed $25 million. In

establishing guidelines for this new program, FHA has recognized that adjacent land development projects, tied together by common services and community facilities, should be considered as one project for the purpose of applying the statutory mortgage limitation under the program.

In this regard, the FHA central office issued in May 1966 program guidelines to its field offices in the form of a series of general questions and answers which included the following items concerning application of the statutory mortgage limitation under the new land development program:

> "What is meant by the 'single land development undertaking' on which at no time may a *** [land development] mortgage in excess of $10,000,000 [increased to $25,000,000 in 1966] be outstanding? ***" (Underscoring was included in quoted material.)

> "***FHA in determining what is a single land development, would look at it from the point of view of whether or not this development stands on its own or whether it is tied into other developments for certain services or community facilities. A large subdivision which is laid out under one overall plan cannot be arbitrarily cut into pieces for the purpose of avoiding definition as a single development. *** Two developments, side by side, sponsored by the same developer could or could not be classified as a single development, depending on the facts in each case." (Underscoring supplied.)

While we recognize that the land development program deals with financing the acquisition and development of raw land for future building sites, as distinguished from the acquisition or construction of housing units, we believe that the question of how the mortgage limitation under that program should be applied involves generally the same considerations as the statutory limitation for cooperative housing projects such as Leisure Worlds.

We believe further that the separately mortgaged segments of a Leisure World community are closely tied together

with respect to certain services and community facilities. Therefore, FHA's application of the statutory mortgage limitation to Leisure World community segments seems to us to be in contrast to the guidelines quoted above concerning the statutory limitation in the new land development program.

LAND APPRAISALS INCLUDE INCREASES IN VALUE CREATED BY PUBLICITY OF THE PLANNED DEVELOPMENT AND BY CONSTRUCTION PROGRESS

The treatment by FHA of each segment of a Leisure World community as a separate project for mortgage insurance purposes resulted in substantial increases in FHA land appraisals, attributable in part to increased values created by the publicity of the planned community and by the construction made possible by the Government's insurance of the mortgage loans financing that construction.

Under normal FHA underwriting procedures for determining the amount of an insured mortgage loan for a multifamily housing project, FHA estimates the fair market value of the land at the time the commitment to insure the mortgage loan is issued, which is generally prior to the beginning of construction of the project. In applying this procedure to a Leisure World community, FHA estimated the fair market value of the land in each individual segment of the community at the time the mortgage insurance commitment for such segment was issued. FHA's appraisals for the various segments of the community gave recognition to increased land value created by the publicity of the planned development and by previously completed dwelling units and other improvements within the community; however, available information did not show the extent to which the total increases in value of the various segments of land were attributable to such factors.

Section 227 of the National Housing Act (12 U.S.C. 1715r) provides that the amount of an insured mortgage loan be based, in part, on FHA's estimate of the fair market value of any land prior to the construction of improvements built as part of the project. This provision was added to the National Housing Act in 1954 and was explained in Senate Report 1427 (83d Cong. 2d sess.). The report states, in part, that, if a project is built on raw and unimproved land, the land value must be on that basis and not on the basis of the value when the proposed improvements are completed.

We were advised by FHA in January 1967 that FHA had interpreted this provision as being applicable to individual

segments of a Leisure World community rather than to the community as a whole and that, in appraising the raw land for a given segment, FHA could not disregard the effect on land value of dwelling units, improvements, and community facilities already constructed within the community.

FHA records showed that the entire tract of raw (unimproved) land planned for the Leisure World community at Laguna Hills, consisting of about 1,800 acres in a relatively undeveloped part of Orange County, California, was purchased by the developer in December 1961, along with a large amount of adjacent land, at an average price of about $2,600 per acre. Two years later, in December 1963, FHA appraised the land for the first segment of the community at $10,500 per acre. FHA's appraisals of the land in subsequent segments gradually increased by substantial amounts as construction of the community progressed until, for the 20th segment, the land was appraised in January 1967 at $18,500 per acre. In total, FHA's appraisals of land for the first 20 segments of the community, which covered about 500 acres of land, exceeded the purchase price paid by the developer, as shown in FHA records, by about $6 million.

Because we had no authority to audit the developer's records, we did not attempt to ascertain the costs incurred by the developer for such things as rezoning expenses, interest, and taxes paid from the purchase date to the dates of conveyance of the first 20 land segments to the cooperative mortgagor corporations at the Laguna Hills community; however, assuming that such costs represented annually about 20 percent of the purchase price, the total of such costs would have been approximately $1 million--leaving a difference of more than $5 million between the aggregate of the FHA appraisals and the developer's purchase price and estimated holding costs.

According to FHA land appraisal documents, the publicity and the site development that had taken place were major factors contributing to the initial FHA appraisal of $10,500 per acre--which exceeded the average purchase price paid by the builder 2 years earlier by about 300 percent--as well as to the subsequent FHA appraisals of land in the succeeding segments of the community--which exceeded the average purchase price by amounts ranging up to 600 percent within 3 years after the initial appraisal.

The appraisal documents stated that prices of land near the planned community, which were used as a basis for appraising the land within the planned community, had progressively increased by significant amounts due to the publicity and the site development that had taken place. An FHA appraiser of a number of the property segments of the planned community explained that the appraisals were based on a consideration of the amount of construction completed or under way in the community, including community facilities and other improvements. However, we were unable to identify from available information the amounts of the increases that resulted from FHA's consideration of these factors.

With regard to FHA's initial appraisal of land to be used for a large, self-contained community, FHA records showed, for example, that the tract of raw land planned for the Leisure World community in Seal Beach, California, approximately 540 acres, had been purchased by the developer in April 1961 at a price of about $13,800 per acre. Three months later, in July 1961, FHA appraised the raw land for the first segment of the community at about $20,000 per acre. Within 6 months after FHA's appraisal of the first segment, FHA appraised the raw land for the second segment at about $24,400 per acre. In total, the FHA appraisals of the raw land in the entire community, which were all made within about 3 years after the developer acquired the land, exceeded the amount shown in FHA records as the purchase price to the developer by about $4 million, excluding costs such as rezoning expenses, interest, and taxes paid by the developer during the 3-year development period.

The FHA land appraisal amounts cited above for the Leisure World communities at Seal Beach and Laguna Hills do not include the additional amounts allowed by FHA, as part of its estimate of the total fair market value of the land, to cover the cost of community facilities and other land improvements within the community.

We note that the Housing and Urban Development Act of 1968 authorized a new program under which HUD can guarantee bonds, notes, or other obligations issued by developers of new communities to help finance the acquisition of land and the installation of basic facilities needed to ready the

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land for further development. The maximum amount of a guaranteed obligation under this new program is based in part on HUD's estimate of the value of the land before development. In its report on the bill which was enacted as the Housing and Urban Development Act of 1968 (S.R. 1123, 90th Cong., 2d sess.), the Senate Committee on Banking and Currency instructed HUD to exercise the greatest care in the valuation of land under the new program. Also, in that report the Committee stated, in part, that:

> "In making an estimate of value to the greatest extent possible, reliance should be placed on recent actual prices in arm's length sales transactions of the land involved or of nearby comparable land. Also, while it is reasonable to disregard, as unrepresentative of present values, transactions made at considerably earlier periods when local land values were much lower, it is equally important that unusually high prices paid for remaining parcels needed to round out a site, or resulting from the guarantee application becoming known to sellers, be considered as unrepresentative of values of the site as a whole.
>
> "Similarly, while it is reasonable to take into account rising sales prices resulting from the influx or expected influx of population or of commerce or industry into the area, it is definitely not the intention of the committee that the valuation take into account the increased values resulting from the guarantee expected to be issued under this title, and the development made possible by that guarantee, as distinct from normal growth that would have been expected in any event." (Underscoring supplied.)

We recognize that, as pointed out by HUD and the builder in commenting on a draft of this report, the new program authorized by the Housing and Urban Development Act of 1968 deals with acquisition and development of land and the preparation of sites for future construction of new towns rather than for the construction of housing projects and that the Leisure World developer did not receive

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Government assistance in the financing of the acquisition and improvement of the land for the communities prior to the beginning of the construction of the housing units on the land.

It appears, however, that a situation similar in principle to the situations which the Committee on Banking and Currency has sought to prevent regarding the new towns program authorized by the 1968 act has occurred in the case of the Leisure World communities and could occur again in large communities of this type that may be initiated in the future. As previously discussed in this section of our report, FHA's appraisals of land for a Leisure World community gave recognition to the publicity of the planned community and to the construction made possible by the Government's insurance of the mortgage loans financing that construction.

Because the FHA land appraisals generally became the land prices paid by the cooperative consumers to the builder, the builder received the benefit of the increases in value resulting from the progress and publicity of the development, in addition to any profit that it may have realized on the construction of the dwelling units and other improvements within the Leisure World communities under construction contracts with the mortgagor corporations. In the cases we reviewed, the amounts of the construction contracts were generally based on FHA estimates of construction costs, which included allowances of about 6 percent for builder's profit and general overhead. However, under the lump-sum type of contract used in those cases, the amount of construction profit realized by the builder would have been dependent on his actual construction costs and, therefore, could have been either more or less than the profit allowance included in the FHA estimates.

Legislative history indicated to us that the section 213 cooperative housing program was generally intended to assist in providing housing at reduced costs to consumers in order to bring more housing within the reach of middle-income families who were not being served under other Government housing programs. Senate Report 1472, Eighty-third Congress, second session, on proposed amendments to section 213 in 1954 stated, in part, that:

"When section 213 was enacted, the Congress intended to encourage the provision of housing by genuine cooperatives consisting of members who banded together initially to construct housing for their own use at savings to them. ***" (Underscoring supplied.)

The report cited above also instructed FHA to administer the section 213 program so that the primary benefit served by that program would be reduced costs to consumers.

House Report 913, Eighty-fourth Congress, first session, on the bill which became the Housing Act of 1955 stated that the principal objective of the section 213 cooperative housing program was the provision of good housing at lower cost to consumers, particularly those in the middle-income group, and that procedures should be established to ensure that the benefits under section 213 would accrue to consumers.

Under the circumstances discussed in this report, the prices paid by the cooperative consumers for their dwelling units included amounts for land which far exceeded the purchase price paid by the developer who had acquired the land specifically for the purpose of building the Leisure World communities. We believe that the Congress may wish to consider whether FHA's land appraisal procedures are appropriate for cooperative housing communities of this size and type, which may be initiated in the future.

CHAPTER 3

AGENCY AND BUILDER COMMENTS AND GAO CONCLUSION

The Under Secretary of Housing and Urban Development advised us by letter dated September 8, 1969 (app. I), that HUD doubted that it would be practicable or desirable to apply the $20 million mortgage limitation to the aggregate amount of mortgage loans for a planned large community such as those discussed in this report. The builder of the Leisure World developments, by letter dated September 9, 1969 (app. II), stated that HUD's interpretation of the limitation was the only proper interpretation that could be made with regard to a Leisure World development.

We do not contend that the $20 million limitation should be applied to the aggregate amount of mortgage loans for an entire community. We believe, however, that the Congress, in placing the mortgage limitation in the law, and the House Committee on Banking and Currency, in explaining in 1955 how the limitation was to be applied to contiguous rental-type projects, may not have contemplated that FHA would undertake to insure mortgage loans of an unlimited aggregate amount for a self-contained cooperative housing community comprising a number of closely related property segments which depend upon each other for the financing of costs associated with the acquisition, ownership, maintenance, and/or operation of a wide variety of common recreational, educational, and other types of community facilities, services, and improvements.

The Under Secretary stated that, if a separately mortgaged property segment was a reasonably viable housing entity standing alone (or with community facilities conveyed to it) and if there was disclosure to the buyer of precisely what he was acquiring for the purchase price and the degree to which future development and future community facilities were dependent upon future sales, there appeared to be no reason to prohibit segmentary development of large communities. In this regard, the builder stated that (1) each purchaser was fully advised, at the time of purchase, of possible reductions in community facilities and services and possible increases in costs in the event that

development did not continue and (2) established procedures afforded protection at each Leisure World community to ensure that, at any stage of development, the residents would have sufficient facilities to take care of their needs.

HUD's approval of mortgage loan insurance for various segments of a Leisure World development was not based on a determination that each separately mortgaged segment could stand alone, having its own individual community facilities. As described beginning on page 11 of this report, the various segments of a Leisure World development are closely related in that they have been planned as integral parts of a self-contained community, to share in the ownership, use, and related acquisition and operating costs of a substantial amount of community property and facilities. Our review of available data related to selected Leisure World property segments showed that HUD had not evaluated the financial aspects of each segment on the basis that each segment would stand alone, completely independent of other existing or planned segments of the development.

We noted that, in a letter dated November 30, 1968, to the residents of the completed segments of the Leisure World community in Maryland, the builder stated, in part, that:

> "You *** [and the developers] are all vitally interested in achieving financial stability here at Rossmoor. The key to this objective is the resumption of construction and sales of dwelling units. Sales of new manors not only are necessary to generate funds for construction and acquisition of community facilities such as the golf course, meeting hall, medical facilities, etc., but also to protect monthly assessments against unacceptable increases.
>
> "The original concept for this community contemplated a sufficient number of occupied manors to support the operation and maintenance costs of the mutuals and the needed community facilities. At the present time the community consists of 898 manors - too few to insure a minimal monthly payment. The sale of new manors will assist the

operation of the community by producing income to defray costs until such time as the project achieves a size that is self-sustaining. The present plan *** calls for the construction and sale of approximately 3400 new manors. These units, in addition to the existing 898 manors and 36 models will be more than sufficient to provide the economic base to protect the investment of all Rossmoor Residents."

Similarly, in a letter to the FHA insuring office in Washington, D.C., dated February 5, 1969, the attorney representing the mortgagor corporations (made up of the residents of the completed units) of the community in Maryland made the following comments in requesting FHA approval of certain aspects of the revised plans for further development of the community:

"*** All interested parties must recognize, as my clients do, that the commencement of new sales at Rossmoor-Maryland is almost essential to the economic survival of the project as we now know it. Funds must be generated for the maintenance of community facilities and the provision of community services over and above the funds which are generated out of the collection of monthly payments. New sales is the only logical source of these funds. The current proposal will provide funds for the maintenance of the golf course from new sales and, hopefully, thereby curtail or perhaps eliminate any need for the generation of funds from play by non-residents or greens fees levied upon play by the residents. The Agreement [between the existing mortgagor corporations and the developers concerning future development at the community] contemplates the continued collection of funds for the future acquisition of additional community facilities and the curtailment of indebtedness on existing facilities. *** The arrangements set forth above also contemplates the collection of $500.00 per new unit for the purpose of funding operating and maintenance deficits incurred in connection with community facilities and services ***.

In addition, *** a provision has been made for moneys to be collected from the sale of each new unit at Rossmoor-Maryland for the exclusive purpose of acquiring the golf course located at that project. This last consideration is, quite naturally, paramount in the minds of our clients.

"*** [the directors and officers of the cooperative mortgagor corporations] have concluded that it is far better to keep future development as a part of the existing community and thereby maintain a voice in the determination of its nature and direction. ***"

In our opinion, the separately mortgaged segments of a Leisure World community are, essentially, interdependent fragments of one large self-contained project or planned project rather than separate and independent contiguous projects as may have been envisioned by the House Committee on Banking and Currency when it explained in 1955 how the statutory mortgage limitation was to be applied to contiguous rental-type projects.

Regarding the builder's comment that purchasers were advised, in advance, of the possible effects of not completing the development as planned, we noted that the builder, in commenting on our observations concerning land appraisals, stated that Leisure Worlds had been sold on the basis of providing a way of life and that the image created by the community facilities in existence prior to the beginning of the sales program was very important in creating a value to the property.

As described on pages 16 and 17 of this report, many of the community facilities within a Leisure World development, including those completed prior to the sale of dwelling units within the development, are not conveyed to the trustee for the residents until substantial numbers of dwelling units are sold. Although enhancing sales and property values early in the development stage, the concept of a way of life and the image created by existing facilities may not materialize unless a substantial part of the planned development is completed. Thus, ownership of all of the existing community facilities might not be

transferred to the trustees for the residents and there would be no assurance that these or other planned facilities would be available for the use of the residents as contemplated.

The builder stated that our analogy of the limitation on loans insured under the land development program enacted in 1965 (see pp. 17 to 19) with the $20 million limitation on mortgage loans insured under section 213 was not valid in that the insurance risk on a mortgage loan for raw land to be developed in the future was entirely different from the risk on an insured mortgage loan for a development such as Leisure World, which required presale of 90 percent of the memberships.

While the nature and degree of mortgage insurance risk may vary, depending upon the type of property involved, it appears to us that the situation with respect to whether a mortgaged property stands on its own or is tied into other properties by common services and community facilities would generally have a similar effect on the mortgage insurance risk, regardless of whether the property involved is a land development project or a cooperative housing project.

The builder stated that there were numerous projects under way in California that envision several thousand single-family homes to be financed by FHA- or Veterans Administration-insured loans or conventional loans. He stated that, if FHA were subject to a $20 million limitation, such large numbers of homes could not be built and that FHA, accordingly, had not imposed the $20 million limitation on single family housing developments. He stated that FHA followed a similar procedure in its application of the $20 million limitation to cooperative housing.

The $20 million limitation provision discussed in this report is set forth in section 213 of the National Housing Act and is applicable only to multifamily cooperative housing projects financed under that section. Although there are similar mortgage limitations in other sections of the act governing mortgage insurance for other types of multifamily housing projects, there is no comparable limitation in the law governing the basic program under which

mortgages on single-family properties are insured. It appears to us, therefore, that FHA's interpretation of the $20 million limitation on multifamily cooperative housing projects financed under section 213 has no relationship to, and no effect on, the financing of single family homes.

The builder acknowledged, regarding our comment that the ultimate control over the completion of the communities as planned rested in the hands of the builder (see p. 15), that he had not made any commitments as to future availability of the land needed for completion of the development as planned but stated that this situation had not subjected the sponsor to the builder's control nor affected the rights and ownership interests of potential purchasers. As an example, the builder gave a detailed explanation of the conditions and circumstances related to the suspension of sales at the Maryland Leisure World development.

We do not contend that the situation concerning the ownership or control of land has had an actual adverse effect on the development progress of the Maryland community or any of the other Leisure World communities. We believe, however, that such a situation could have an adverse effect regarding future developments of the nature and magnitude of the Leisure World developments, since, once a planned development has been partially completed and occupied, the sponsors or mortgagors have no choice but to deal with the owner of the land needed for completing the development as planned, whereas the landowner could, conceivably, sell the needed land to other parties for other uses.

The Under Secretary of HUD stated concerning land appraisals that the idea of limiting land appraisals for mortgage insurance purposes, through a protracted period of development and sale, to the initial value or price of the raw land plus development cost was unlikely to prove practicable because developers could not be expected to sell land for less than the available market price. The builder stated that, according to our contentions, the Government should never give any consideration to a valuation of land in excess of the acquisition price of the land to a builder-landowner.

The question we have raised is not whether HUD should limit its land appraisals for mortgage insurance purposes to the acquisition cost of raw land plus development costs but whether HUD's appraisals for a planned, self-contained, cooperative housing community being developed in segments should include increased values created by the construction progress and publicity of the development.

We believe that this question is particularly important and pertinent in view of (1) the general requirement in the law that an insured mortgage on a multifamily housing project be based on the fair market value of land prior to the construction of improvements built as part of the project (see p. 20), (2) the stated legislative intent that HUD's land appraisals under the new towns program enacted in 1968 should not include increases in value resulting from HUD's loan guarantees under that program (see pp. 22 and 23), and (3) the stated congressional intent that the primary benefit to be served by the section 213 cooperative housing program, under which the Leisure World mortgage loans were insured, is reduced costs to the cooperative consumer groups.

The builder did not agree that the increases in Leisure World land values were attributable in large part to the publicity of the planned community or construction made possible by the Government's insurance of the mortgage loans. He stated that HUD's insurance of mortgage loans played only a minimal part in determining the value of the land. He stated further that the sale of Leisure Worlds on the basis of providing a way of life required careful planning and extensive investments before any dwelling units were offered for sale and that the image created by community facilities in existence prior to the beginning of FHA's insurance of mortgages was very important in creating a value to the property.

Concerning the builder's comments presented above, we found during our review that the FHA-insured mortgage loans financing the purchase prices paid by the mortgagors to the builder for the first and each succeeding group of dwelling units included amounts for (1) the estimated fair market value of the raw land underlying the dwelling units, (2) an

allocated portion of the estimated construction cost of all completed and planned community facilities and other common improvements within the community, and (3) the estimated construction cost of the dwelling units themselves.

As described on pages 21 and 22 of this report, information contained in FHA's land appraisal documents and statements made to us by FHA representatives indicated that (1) the publicity and site development at the Laguna Hills community were significant factors contributing to the increases in FHA's land appraisals, (2) the appraisal increases were based on a consideration of construction completed or under way within the community, and (3) FHA, in appraising the land for a given segment of a community, could not disregard the effect on land value of dwelling units, community facilities, and other improvements already constructed within the community.

In view of the basic intent of the section 213 cooperative housing program and the magnitude of the Leisure World developments, we believe that the question as to whether HUD's land appraisals for such a community should include increases in value created by the community itself is a matter that warrants congressional consideration.

The builder stated that our presentation of the data concerning FHA's appraisals of land for the Laguna Hills development did not take into account the fact that some of the acreage had been subjected to restricted use and that some acreage was not suitable for use. He stated that the average price per acre paid by him for the total tract would be increased if the restricted and unusable parcels were eliminated from the computation of the average price per acre.

Internal FHA instructions provide that, as part of the justification for the estimated land value for a project, the FHA appraisers must ascertain the original acquisition cost of the land. In arriving at the land acquisition cost shown in FHA appraisal documents for each segment of the Laguna Hills development covered by our review, FHA appraisers used the average cost per acre paid by the builder for the entire tract of land. The per acre acquisition cost cited in our report is the same as that used by FHA appraisers in computing acquisition cost.

CHAPTER 4

MATTERS FOR THE CONSIDERATION OF THE CONGRESS

In view of the magnitude and nature of the cooperative housing developments discussed in this report and the possibility that similar developments may be initiated in the future, the Congress may wish to consider whether statutory provisions and HUD administrative procedures relating to mortgage loan insurance ceilings and land appraisals are appropriate for such developments.

CHAPTER 5

SCOPE OF REVIEW

We reviewed the basic laws and related legislative history governing FHA's mortgage insurance program for cooperative housing projects, and we examined various records and documents pertaining to FHA's processing of mortgage insurance applications for the Rossmoor Leisure World developments. In addition, we had meetings and discussions with representatives of FHA and various individuals representing the sponsors, mortgagors, and management agent involved in these developments. Our review was made at the HUD headquarters office in Washington, D.C.; the FHA insuring office in Los Angeles, California; the Leisure World management office in Laguna Hills, California; and at three Leisure World development sites.

APPENDIXES

THE UNDER SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D C 20410

Sep. 8, 1969

Mr. Max Hirschhorn
Associate Director
Civil Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Hirschhorn:

We appreciate the opportunity to review the draft of your proposed report to the Congress on certain legislative and administrative considerations regarding mortgage insurance for large cooperative housing communities. We are offering our comments on the two broad points which you raise for consideration of the Congress.

The first of these points suggests that Congress may wish to consider whether no development should take place in segments under separate mortgages aggregating a combined mortgage amount more than $20 million if the segments fit into a whole community in which the full development of all planned community facilities depends to a degree on completion and sale of the entire community. We doubt that this is a practical or desirable limitation. If the housing project covered by a mortgage is a reasonably viable housing entity standing alone or with the community facilities conveyed with it and if there is disclosure to the purchaser of precisely what he is acquiring for the purchase price and the degree to which future development and future community facilities are dependent upon future sales, there would appear to be no reason to prohibit large developments of this kind in segments.

With respect to the second point raised for consideration, the idea of limiting land value recognized for mortgage insurance throughout a protracted period of development and sale to the initial value or price of the raw land plus development cost is unlikely to prove practicable. It assumes that the developer will be willing to sell his land at below the market price currently obtainable in later stages of the development. A prudent and practical developer cannot be expected to sell land below the available market price. The land development mortgage

insurance program and the program for guarantee of obligations to finance land development provided by the Housing and Urban Development Act of 1968 referred to in your draft report are not analogous since they cover the development of the land, not the eventual marketing of the houses and lots in the development.

I hope that these views are helpful to you in connection with your consideration of the draft report.

Sincerely,

Richard C. Van Dusen

AIR MAIL

September 9, 1969

ROSS W CORTESE
PRESIDENT
ROSSMOOR CORPORATION

M F WARD
Executive Vice President
R I RICNEY
Vice President Finance
A R CERESA
Administrative Vice President
R F ROSENWALD
Vice President General Counsel

Mr. Max Hirschorn, Associate Director
United States General Accounting Office
Civil Division
Washington, D. C. 20548

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Dear Mr. Hirschorn:

Rossmoor Corporation has reviewed a draft of REPORT TO CONGRESS OF THE UNITED STATES - REVIEW OF CERTAIN LEGISLATIVE AND ADMINISTRATIVE QUESTIONS REGARDING MORTGAGE INSURANCE FOR LARGE COOPERATIVE HOUSING COMMUNITIES submitted to Mr. Cortese, President of Rossmoor Corporation, under cover of your letter dated July 29, 1969.

Your report basically relates to two prime "questionable" matters involved in insuring mortgage loans for large cooperative housing communities. In each instance you have criticized the governmental agency responsible for supervision, authorization and insuring of large cooperative housing communities and the techniques used therein. We disagree with the criticism and fully believe that the governmental agency in all respects complied with the law governing cooperative housing communities as will be hereafter set forth.

The first matter set forth in your report had to do with the absence of limitation on the amount of mortgage insurance for a self-contained cooperative housing community. You refer to a statutory $20,000,000 limitation and conclude that this should apply to a total Leisure World community rather than to a mortgage loan or loans on each individual cooperative housing corporation. Your conclusion is not based upon any law which governs cooperative housing projects but is based upon an analogy to other acts of Congress related to different types of housing and/or land development. Primarily they related to land development loans. No land development loans were ever insured by F.H.A. in connection with any of the Leisure Worlds. Full disclosure was made to F.H.A. of the scope of each Leisure World project. Thereafter each cooperative housing corporation was required by F.H.A. to fully qualify with the requirements for an insured mortgage loan.

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The purpose of the $20,000,000 statutory limitation is primarily related to insurance risk. The question of risk on a loan for raw land to be developed into a new town in the future is entirely different from the risk taken for housing which requires presale of 90% of the memberships in a cooperative being sold before F.H.A. will insure a mortgage loan. Therefore it is quite apparent that an analogy to a statutory limit for raw land is not correct for consideration for an insured loan of a presold development. If F.H.A. were subject to a $20,000,000 statutory limitation on housing, it would be impossible for any type of home ownership to be sustained on a volume basis. For example, in Orange County, California, there are numerous projects under way today that envision several thousand single family homes to be financed alternately under F.H.A. or V.A. insured loans or conventional financing. As a result of the future development of several thousand homes, various amenities are capable of being provided for the use of the ultimate home owner although each home has its independent mortgage. However, by analogy to your methods of statutory limitation, it would be impossible today to have a several thousand unit development in any segment of our community since, in the aggregate, the insured loans would exceed the $20,000,000 statutory limitation. The only method, however, of reaching a practical interpretation of the law as far as the statutory limitation is concerned, is to look at each proposed mortgage loan. F.H.A. has accordingly in single family housing looked at each loan and is thereby not affected by the statutory limitation. The same viewpoint is taken by F.H.A. in a cooperative housing form of ownership. We believe that the practical interpretation is also the legal interpretation and is the only proper interpretation in connection with a Leisure World development.

In the same section where you raise the question of statutory limitation you refer to the fact that the communities as planned rested in the hands of the builder and that the builder "was not committed to continue selling the land to the mortgagors or sponsors as construction of the communities progressed." Thereafter you indicate that the sales and construction of the Maryland community were suspended in September, 1967. The implication is that since control is in the hands of the builder-landower, the sponsor was then subject to the builder's determinations which would ultimately affect the rights and ownership interest of potential purchasers. Nothing could be further from the truth and Maryland is a good example to prove that this conclusion is erroneous.

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It is true that the sales of Maryland units were suspended in 1967; however, suspension of such sales occurred by order of the sponsor. The builder-land owner did not concur in such suspension of sales. However, the builder-land owner had no commitment on the part of the sponsor or mortgagor as to future development. In fact, at the time of suspension of sales plans were well under way by the builder-land owner for future development of the Maryland Project and the builder-land owner was not able to complete these plans because the sponsor had elected not to proceed with the sales. Furthermore, at the time of suspension, as your report points out, the trustee for the community owned free and clear a clubhouse. Not pointed out, however, was the fact that this clubhouse has an approximate value of $1,500,000 and was deeded to the trustee at the time of the first mortgage closing, and at the time of suspension in excess of $700,000 was still owed to the builder-land owner, which amount the builder-land owner will be able to recover only from future new housing unit sales.

On June 21, 1969 the builder-land owner itself resumed sales of the Maryland Project. Resumption of sales at the Maryland Project was due to two factors: (a) a conversion from cooperative housing to condominium housing, and (b) the availability of conventional financing as a result of such conversion. In 1967 the sponsor was unable to get reasonable F.H.A. insured financing because of the statutory interest limitation on 213 loans. For several years prior to suspension the sponsor had brought to the attention of the government that the statutory limitation of interest rate on 213 loans from governmental authorities was too low but was unable to get any consideration about eliminating the then unmarketable interest rate restriction. Financing a cooperative became almost impossible in 1967. As a result the sponsor decided to discontinue development and the sponsor thus was unwilling to purchase land from the builder-land owner. The builder-land owner at no time refused to sell land to the sponsor nor did it refuse to continue with the development of the project. While it is true that the builder-land owner did not make any commitments as to the future availability of land, it is also true, as Maryland illustrates, that the sponsor-mortgagor had no commitment with the builder-land owner to purchase land from the builder-land owner. The entire risk, therefore, as to the undeveloped portion of land fell upon the builder-land owner.

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Mr. Max Hirschorn
September 9, 1969
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With reference to the circumstances relating to suspension of sales, each purchaser was fully advised at the time of purchase that if less than the planned number of units were sold, community facilities and services would be proportionately reduced Furthermore, each purchaser was advised of the possibility of increased costs in the event development did not continue or that development was not of the number projected. Protection, however, was afforded to assure that any purchaser who did purchase a housing unit had a certain number of amenities which would amply take care of all residents at each stage of development and that these amenities would be owned free and clear by the trustee for each community. Thus, at the time of the purchase of the first unit at Laguna Hills, this community owned a clubhouse having an approximate value of $1,500,000. The builder-land owner, however, did not receive full payment for this community facility until approximately 2,500 units had been sold. Thus, in the event the development of Laguna Hills stopped short of 2,500 units, the community still owned the clubhouse and still had available to it this community facility free and clear. The same procedure was used at all other Leisure World projects. At Walnut Creek, for example, four clubhouses were provided to the community to serve less than 3,000 units. All these clubhouses have been conveyed to the trustee of the community by the builder-land owner. According to the established procedure at each Leisure World the residents of the community are to be afforded assurance that they will have sufficient facilities to take care of their needs. As additional units are constructed, other facilities will be added in advance of need. Thus, at each Leisure World community, community facilities have always exceeded the need at the outset and as residential units are sold, additional community facilities are added for the community so that there are always more community facilities than the actual need until final development, at which time the community facility need and community facilities provided are equal. We believe that F.H.A., in assuring to the residents that there are adequate community facilities in advance of need, has adequately safeguarded not only the security underlying the insured loans but, more important, the needs of the residents.

Your second questionable item had to do with land appraisals including increases in value provided by publicity of the planned development and by construction progress due to F.H.A. insured loans. We disagree entirely that the value of the lands at

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Leisure World increased to a large part because of the publicity of the planned community as well as the construction made possible by the government's insurance and the mortgage loans financing that construction. Leisure Worlds have been sold on the basis of providing a "way of life". This way of life has been developed by careful planning. The mere fact that F.H.A. insured the mortgage had only a minimal importance in the sale of Leisure World units. Each area selected for a Leisure World required extensive planning prior to opening. In Maryland, New Jersey, Walnut Creek and Laguna Hills the builder-land owner was required to make extensive multi-million-dollar investments before any units were even offered for sale. The image created by already having in existence for the use of the first Leisure World residents adequate facilities to take care of their every need was very important in creating a value to the property

You have referred to Laguna Hills as an example of F.H.A. granting to the builder-land owner significant increased valuation over and above the assumed purchase price per acre When land is acquired in large sections it is erroneous to ascribe an average value per acre since portions of the property may or may not be useable for development. Your Laguna Hills example did not take into account the fact that several hundred acres of this land have been subjected to restricted use. If this restricted area were eliminated then your average price per acre would be increased. You have also not taken into consideration properties that because of topography would not be susceptible to use, but they were included in order to obtain the entire parcel of property. By eliminating unusable property the average price per acre again would be increased. It is clear that an average price per acre can never be considered a proper measuring stick for land value. Each increment must be valued separately according to use. Thus each mortgage parcel requires separate value determination. At Walnut Creek the F.H.A. appraised value changed from location to location. In some instances F.H.A. appraised a portion of property at an "average price per acre" lower than a portion appraised for a previous mortgage parcel. F.H.A. thus realized that merely because one section of land contained the exact same net usable acreage as another parcel the average price per gross acreage may be substantially different.

Between the time of acquisition in December of 1961 and the opening for sale of the Laguna Hills project in January of 1964 in excess of $12,000,000 was invested by the builder-land owner

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to insure that the community would have available to it certain community facilities, shopping conveniences, roads, utilities, land, etc. Shortly after acquisition of the Laguna Hills property the builder-land owner announced that it was going to develop a shopping center. Adjacent acreage then began to develop. This acreage was developed under single family home ownership insured by government insurance and appraised by F.H.A. The F.H.A. appraisals of these areas provided comparable value relating to the value of the Leisure World property. It is our understanding that F.H.A. based their appraisals on fair market value, which, as indicated in your report, is the proper method for value of land. It is impossible to believe, as you contend, that the value of property should not have increased for F.H.A. appraisal purposes. The valuation of land at all times for Leisure World purposes was based upon a thorough analysis of market value and the aspects of publicity of the planned community as well as the government insurance played only a minimal part in the determination of the value of the land.

Your analogy to new towns and the intent of Congress is sound only if the government were to help in the financing of the acquisition of the land and the development of the basic facilities. Leisure World did not have any government assistance in the acquisition of land nor the development of the basic facilities. Acquisition of land and the development of the basic facilities was always done conventionally at the sole risk of the builder-land owner. If the development was not a success, it would be the builder-land owner who bore the bulk of the risk and not the government as an insurer.

It is interesting to carry out your contentions to the logical result that the government should never give any consideration to a valuation over and above the acquisition price of the builder-land owner. Hence, if the builder-land owner acquired the property at no cost, then F.H.A., if it were required to appraise that property, should not give any value to the raw land. However, local governmental agencies seem to disregard entirely the cost of property when it comes to taxing property. Real property taxes are based upon fair market value and as a result the value for tax purposes increases each year. As real property values increase for tax purposes, it is only proper and sound that F.H.A. would recognize that the fair market value of the land must have increased and as the law requires under a 213 program, F.H.A. must allow for appraisal purposes the land to be

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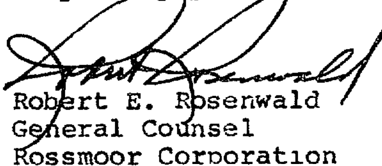
valued at its fair market value. We, therefore, believe that at all times the procedure followed by F.H.A. in appraising land was proper and in accordance with the law.

There are a number of other minor matters raised by your report which we take issue with; however, we basically disagree with all of your conclusions and findings. We strongly urge that each type of housing must be considered on an independent basis. It is unfair and unsound to compare financing of land and improvements for a new town with financing of the construction to be built on already acquired and paid-for land. Likewise it is unsound to compare programs for rental housing with programs for cooperative housing or programs for low-cost housing or programs with single family housing. To take a small part of one program for comparison in determining rules and regulations of another program without consideration of the whole cannot possibly arrive at an objective or proper result.

We believe that the objectives of the cooperative housing mortgage insurance program were known to the governmental agency having responsibility for regulating it and were properly supervised and followed by this agency. Because of their careful review and consideration, the Leisure World projects have continued to fulfill the need of the cooperative housing program designed by Congress.

Very truly yours,



Robert E. Rosenwald
General Counsel
Rossmoor Corporation

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PRINCIPAL OFFICIALS
OF THE
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES
DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (formerly Administrator, Housing and Home Finance Agency):		
Robert C. Weaver	Feb. 1961	Dec. 1968
Robert C. Wood	Jan. 1969	Jan. 1969
George Romney	Jan. 1969	Present
ASSISTANT SECRETARY-COMMISSIONER, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, FEDERAL HOUSING ADMINISTRATION (formerly Commissioner, Federal Housing Administration):		
Neal J. Hardy	Mar. 1961	Jan. 1963
Paul E. Ferrero (acting)	Jan. 1963	Mar. 1963
Philip N. Brownstein	Mar. 1963	Feb. 1969
William B. Ross (acting)	Feb. 1969	Sept. 1969
Eugene A. Gulledge	Oct. 1969	Present

U S. GAO, Wash., D.C