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Report to the Congress; by Elmer B. Staats, Comptroller General.

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Authority: National Housing Act, as amended, sec. 518(b) (12 U.S.C. 1735b(b) (Supp. V)); S. 4368 (92nd Cong.). National Housing Act, sec. 235 (12 U.S.C. 1715z). National Housing Act, sec. 203 (12 U.S.C. 1709). National Housing Act, sec. 221 (12 U.S.C. 17151). Housing and Community Development Act of 1974. Emergency Housing Act of 1975. Housing Authorization Act of 1976.

Homeowners in Chicago who purchased homes with major defects have been treated unfairly and inconsistently by the Department of Housing and Urban Development (HUD) in their efforts to seek compensation. Ambiguous criteria for evaluating claims and only partial reimbursement were the major deficiencies of the compensation program. Findings and recommendations to rectify the situation are applicable throughout the country. Findings/Conclusions: Better criteria are needed to evaluate the validity of claims. A number of rejected claims are similar to claims considered valid. Homeowners were not always informed of the right to appeal rejected claims. Incorrect partial compensation for valid claims was sometimes granted. Recommendations: HUD should more clearly define criteria as to what constitutes a serious defect. Guidance given inspectors to determine whether defects existed at the time of insurance commitment should pount out the inappropriateness of relying (1) solely on a fixed time limit without regard to other factors in each case, or (2) on the original Federal Housing Administration appraisal. HUD should direct the Chicago area office to discontinue using a fixed time-limit criterion to the exclusion of other factors, resolve serious doubts in favor of the homeowner in evaluating claims, and reevaluate all claims rejected on the basis of inappropriate criteria. Procedures for reimbursement should cover total actual costs, including finance charges, and should be implemented in a

uniform and consistent manner. (DJM)

REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Need For Fairer Treatment Of Homeowners' Claims For Defects In Existing Insured Homes

Department of Housing and Urban Development

While this report is directed at a situation in Chicago where homeowners have been treated unfairly and inconsistently under a Department of Housing and Urban Development program, a number of GAO's findings, conclusions, and recommendations to correct the situation are applicable throughout the Nation.

In Chicago, homeowners were treated unfairly and inconsistently under a departmental program to compensate them for major defects affecting the use and livability of existing homes purchased with federally insured mortgages.

Lack of clearly defined criteria for evaluating the acceptability of homeowner claims for assistance have resulted in inconsistent departmental determinations that frequently were reversed when homeowners appealed the decisions. Also, Chicago homeowners were not fully reimbursed for defects, as prescribed by departmental regulations.

CED-77-97

JULY 27, 1977

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-114860

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

This report discusses the need for fairer treatment of homeowners' claims by the Department of Housing and Urban Development under a program designed to compensate homeowners for defects in existing insured homes.

We made our review at the specific request of Congressman Ralph H. Metcalfe of Illinois, and we testified on it before the Subcommittee on Manpower and Housing, House Committee on Government Operations, in hearings held on April 15, 1977. Because of the national applicability of many of our findings, conclusions, and recommendations, and because of considerable congressional interest in the program, we decided that this report should be issued to the Congress as a whole.

Copies of the report are being sent to the Director, Office of Management and Budget, and the Secretary of Housing and Urban Development.

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

NEED FOR FAIRER TREATMENT OF HOMEOWNERS' CLAIMS FOR DEFECTS IN EXISTING INSURED HOMES Department of Housing and Urban Development

D I G E S T

Chicago area homeowners have been treated unfairly and inconsistently under the Department of Housing and Urban Development's program to compensate homeowners for major defects affecting the use and livability of existing homes. Under section 518(b) of the National Housing Act, as amended (12 U.S.C. 1735b(b)), the Department administers a program to correct or compensate owners of existing homes purchased with federally insured mortgages in which there were serious defects at the time of insurance commitment.

Although this review was directed primarily toward the administration of the program in the Chicago area, GAO is making recommendations aimed at bringing about more objective and consistent evaluations, nationwide, of homeowner claims as well as correcting problems in Chicago. Nationwide, the Secretary of Housing and Urban Development should

--direct that more clearly defined criteria be developed as to what constitutes a serious defect,

--direct that the guidance provided to inspectors for determining whether defects existed at the time of insurance commitment recognize the inappropriateness of relying (1) solely on a fixed time limit without considering other factors of each case, or (2) on the original Federal Housing Administration appraisal, and

--obtain assurance that all departmental field offices are making payments for claims in accordance with established procedures. (See pp. 16 and 20.)

The Secretary should direct the Chicago area office to

--discontinue using a fixed, time-limit criterion without considering other pertinent factors and, rather than relying on original Federal Housing Administration appraisals, be fair and objective, and resolve serious doubts in favor of the homeowner in evaluating claims,

--reevaluate all claims it has rejected on the basis of such inappropriate criteria, and

--pay future claims in accordance with established procedures as well as reevaluate all claims paid to date in terms of these procedures. (See pp. 16 and 20.)

GAO expresses no opinion on the legality or illegality of the Department's operations in this report. Litigation by an association that includes numerous community groups in Chicago is pending. (See p. 1.)

Because criteria governing the program are vague in terms of identifying what constitutes an eligible defect, or how to determine that the defect existed at the time of insurance commitment, area office inspectors and reviewing officials are forced to exercise considerable judgment in interpreting and evaluating claims. As a result, decisions rejecting homeowners' claims have at times been based on inappropriate criteria, and denials of claims have been overturned during the appeals process at about a 45 percent rate. (See pp. 9 and 10.)

The high rate of rejected claims which are appealed successfully is attributable to

--the fact that serious structural defects were not defined adequately (see p. 10),

--inappropriate reliance on the Department's appraisal/inspections made at the time of insurance commitment (see p. 11), and

--the use of a preset time limit on the emergence of defects to the exclusion of other pertinent factors. (See pp. 12 and 13.)

Not all homeowners have appealed rejected claims. Many of these claims appear similar in circumstances to those appealed successfully. (See p. 14.)

Homeowners also were not being fully reimbursed as prescribed by the Department's regulations. About one-third of the claims checked by GAO had been underpaid because the Chicago area office had reimbursed the homeowners on the basis of average replacement cost rather than actual cost. (See p. 18.)

Cost of the program since its inception through January 1977 was about $18.5 million with 22,100 payments having been made. From April 1975 through January 1977 about 76,800 claims were received nationally with 13,900 (or about 18 percent) found valid and acceptable for reimbursement. The Chicago area office received about 13,200 claims from April 1975 through February 1977 and has judged 2,500 (or 19 percent) of them to be valid. (See pp. 6 and 7.)

AGENCY COMMENTS AND GAO'S EVALUATION

The Department agreed with most of GAO's recommendations and indicated that actions have been or are being taken in response to them. (See pp. 22 through 25.)

The Department disagreed with GAO's recommendation that criteria concerning what constitutes a serious defect should be more clearly defined. The Department said that guidelines should not be too restrictive in order that benefit of any doubt should be given to homeowners. Also, the Department pointed out the difficulty in providing guidance covering every situation. GAO recognizes some of these limitations; however, it points out that the guidelines could have been, and should be, strengthened to reflect the experiences of the earlier years of the program in terms of eligible defects. This would add an element of consistency within and among the Department's field offices as they consider the merits of each claim and would result in fairer treatment of homeowners. (See pp. 16 and 17.)

Contents

ABBREVIATIONS

FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development

CHAPTER 1

DESCRIPTION AND STATUS OF SECTION 518(b) HOMEOWNER ASSISTANCE PROGRAM

In accordance with a March 30, 1976, request of Congressman Ralph H. Metcalfe and subsequent discussions with his office, we reviewed the activities of the Chicago area office of the Department of Housing and Urban Development (HUD) concerning its operation of section 518(b) of the National Housing Act, as amended [12 U.S.C. 1735b(b), (Supp. V, 1975)]. Specifically, we

--obtained statistical data on the program, such as the number of applications received, accepted, modified (accepted in part), or rejected;

--identified the criteria used to evaluate the eligibility and validity of program applications, including any local modifications made to the criteria, and

--reviewed samples of rejected applications which have and have not been appealed to contrast HUD's final determinations for each.

On March 16, 1976, the Metropolitan Area Housing Alliance, an unincorporated association that includes numerous community groups in the Chicago area, filed a class action complaint in the United States District Court for the Northern District of Illinois against the Secretary of HUD and other HUD officials. The complaint challenges the procedures utilized by HUD to implement the section 518(b) homeowner assistance program in Chicago. The plaintiffs maintained that the program's various procedural irregularities are violations of the National Housing Act and due process of law as guaranteed by the Fifth Amendment to the U.S. Constitution. On June 6, 1977, the Government's motion for summary judgment was partially granted with other issues remaining. This report expresses no opinion on the legality or illegality of HUD operations.

BACKGROUND

Section 518(b) of the National Housing Act--a homeowner assistance program--was enacted on December 31, 1970, to correct or compensate owners of existing homes for structural or other defects that seriously affect the use and livabilty of any single-family dwelling covered by a mortgage insured under section 235 (12 U.S.C. 1715z) of the same act. Some of the conditions for compensation stated that the defect must

have existed on the date of insurance commitment and that it be one which a proper inspection could reasonably disclose. Also, the homeowner must have requested assistance not later than 1 year after the mortgage was insured.

The section 518(b) program was modified by the Housing and Community Development Act of 1974 and the Emergency Housing Act of 1975 to

--include two-, three-, and four-family dwellings, instead of just single-family dwellings;

--include homes located in older, declining urban areas covered by mortgages insured under sections 203 and 221 of the National Housing Act (12 U.S.C. 1709 and 1715ℓ, respectively) between August 1, 1968, and January 1, 1973;

--correct only such defects which seriously affect use and livability by creating danger to the life or safety of the inhabitants; and

--extend the deadline for filing applications for assistance under sections 203 and 221 to March 22, 1976.

More recently, the Housing Authorization Act of 1976 extended the deadline for filing section 518(b) claims under sections 203 and 221 to December 3, 1976. It also established a section 518(d) which provides coverage similar to that cited in section 518(b) to homeowners with mortgages insured under sections 203 and 221 on or after January 1, 1973, but prior to August 3, 1976. The homeowner must request assistance under section 518(d) by August 3, 1977.

The mortgage insurance sections of the National Housing Act affected by section 518(b) and 518(d) programs are summarized below.

--Section 203 provides mortgage insurance to help homebuyers purchase new or existing one- to four-family dwellings. It is the basic and most commonly used program. Any individual can participate in the program if he or she has a good credit record and can demonstrate an ability to make required investment and mortgage payments.

--Section 221 provides mortgage insurance for the purchase of homes by families displaced by Government action and by families with low- or moderate-incomes. While there are no specific income requirements for eligibility, low mortgage limits available under this

program tend to restrict its use to families with lower incomes.

--Section 235 helps lower income families become homeowners by providing mortgage insurance and subsidizing portions of the monthly payments due under the mortgages. To be eligible for assistance, the family must have an adjusted income not exceeding 95 percent of the median income of the area.

Responsibility for processing, evaluating, and resolving section 518(b) claims was delegated to HUD field offices. Procedures for processing the claims were included in a handbook which, among other things, provided for establishing the (1) eligibility of a claim based on statutory requirements, and (2) validity of a claim based on inspection results or other applicable criteria. The handbook was most recently revised in September 1976.

CRITERIA AND PROCEDURES USED IN EVALUATING CLAIMS AND APPEALS

A homeowner's claim under the section 518(b) program is screened first for eligibility and then for validity after its submission to HUD. If the claim is rejected for either eligibility or validity, the homeowner has the right to appeal the decision and ask for a reconsideration. The criteria and procedures to be used in making these various determinations were established by HUD headquarters for use by its field offices. We found no evidence of the Chicago area office altering or modifying the eligibility criteria. Weaknesses found in the criteria used in making validity determinations will be discussed in chapter 2.

Claim eligibility

A homeowner's claim for assistance under the section 518(b) program is initially screened for eligibility to determine if it meets the following statutory requirements:

--The home must be a one- to four-family dwelling.

--The home must be more than 1-year old on the date of the issuance of the insurance commitment.

--For a section 235 home, the owner must have requested assistance not later than 1 year after the mortgage was insured or by December 31, 1971, if the mortgage was issued before December 31, 1970.

--A section 203 or 221 home must be in an older, declining urban area; the mortgage must have been insured on or after August 1, 1968, but prior to January 1, 1973; and the homeowner must have applied for assistance on or before December 3, 1976.

Section 518(d) extended the period of coverage for homes with mortgages insured under sections 203 and 221 from January 1, 1973, to August 3, 1976. These homeowners must request assistance under section 518(d) by August 3, 1977.

Of the eligibility criteria, the criterion that the home be located in an older, declining urban area is the only one involving any degree of subjectivity. In implementing the statutory provision governing this matter, HUD headquarters determined that an older, declining urban area was a community with a population of 2,500 or more (the census definition of urban) in which at least 50 percent of the dwellings were built before 1940.

HUD instructions provide that when the census tract data indicates an ineligible location, the claim must be field inspected to determine the accuracy of the data. Chicago area office personnel visited areas presumed to be ineligible by the census tract data and identified those areas within the tract that actually could be classified as older and declining. The area office maintained a map of these eligible areas within the ineligible census tracts.

As shown in the table on the bottom of page 7, the Chicago area office rejected 3,920 claims, or about 30 percent of the claims it had processed, on the basis that they were ineligible. We examined 100 ineligible claims and found the following reasons were given for the rejections:

Reason for rejection	Number
Property not located in older, declining urban area	59
Property not insured by HUD within statutory timeframes	34
Claim not submitted within statutory timeframes	8
Property not insured by HUD	1
Total	a/102

a/Two of the claims were rejected for two reasons each.

The fact that properties were not located in older, declining urban areas was primarily why claims were determined to be ineligible. While this criterion is more subjective than the others, we found nothing to suggest that the Chicago area office had altered or modified it. The same holds true with regard to other eligibility criteria.

Claim validity

After a claim is determined to be eligible, it is assigned to a field inspector who inspects the defect or examines documentation and other evidence showing correction of a defect, and renders a judgment as to the validity of the claim. The inspector evaluates the claim according to the following HUD validity requirements.

--The defect must be a structural or major defect which so seriously affects use and livability as to create a serious danger to the inhabitants' lives or safety.

--The defect must have existed on the date the insurance commitment was issued and be one that could be reasonably disclosed by a proper inspection.

HUD guidance on what constitutes a structural or major defect lists the following as being eligible for assistance: (1) worn-out roofs, (2) seriously defective heating systems, and (3) rotten porches and steps. To determine the types of defects for which homeowners were seeking assistance, we reviewed all April 1975 applications determined to be invalid by the Chicago area office and not appealed by the homeowners. Of the 256 applications reviewed, approximately 90 percent fell within the above three categories--roofs, heating systems, and porches and steps.

HUD guidance concerning whether the defect existed at the time of insurance commitment listed the judgment of the field office as the criterion for determining the existence of the defect when no repair requirements were shown on the conditional commitment for insurance. The guidance stated that the test for determining whether a proper inspection should have disclosed the defect was whether the appraiser, operating in accordance with the applicable instructions at the time of the appraisal/inspection, should have observed the defect or anticipated it due to observable conditions.

Statistics presented in the table on the bottom of page 7 show that the Chicago area office rejected 6,611 claims, or about 51 percent of the claims it has processed, on the basis that they were invalid.

Appeal process

Homeowners have the right to appeal rejected section 518(b) claims. If a homeowner chooses to do so, his or her claim is appealed to the area office where it is then assigned to an inspector. The inspector is to reevaluate the claim and recommend to an area office reconsideration committee whether to accept or reject it again. Final decision within the area office regarding the appeal rests with the reconsideration committee.

If a decision is reached in the area office to overturn the initial rejection and thus accept the claim for reimbursement, then the appeal goes no further and is handled by the area office. If, on the other hand, the area office continues to consider the claim either wholly or partially invalid, it is then forwarded to the regional office for additional consideration. Until July 1976 the regional office reviewed the forwarded claim and either reversed the area office's determination or sent its negative recommendation to HUD headquarters, which then made a final decision on the case. HUD headquarters originally wanted final review authority to insure giving homeowners the maximum benefit. However, by July 16, 1976, there were not many headquarters reversals of area or regional office decisions, and sufficient staff was not available for reviewing cases. Headquarters, therefore, delegated the final decision on appeals to the regional offices.

SECTION 518(b) PROGRAM STATISTICS

Although the program has been in effect since late 1970, nationwide statistics developed by HUD headquarters are limited to program activities that have occurred since about April 1975. It was at this time that the program was substantially expanded as a result of revisions to the National Housing Act in 1974, which authorized acceptance of homeowners' claims for defects in properties insured under sections 203 and 221.

HUD's section 518(b) activity status report, as of January 27, 1977, showed that, nationwide, about 86,500 claims and requests for reconsideration were received from about April 1975 to January 27, 1977. As shown in the following table, HUD's Chicago regional office received 39,396 (or about 46 percent) of these claims and reconsiderations.

Region	Claims received	Reconsideration requests received	Total	HUD claims determinations			Claims eligible and in process	Claims awaiting processing
				Valid	Invalid	Ineligible		
Boston	3,012	582	3,594	972	1,600	349	387	5
New York	10,080	2,013	12,093	1,348	7,679	2,945	268	80
Philadelphia	9,715	1,247	10,962	1,278	6,504	2,379	451	20
Atlanta	4,104	363	4,467	289	1,071	3,186	29	22
Chicago	35,253	4,143	39,396	4,837	18,285	13,998	2,109	108
Dallas	3,347	206	3,553	269	903	2,798	27	25
Kansas City	3,187	647	3,834	905	1,450	1,259	108	4
Denver	817	47	864	147	381	382	2	5
San Francisco	5,562	191	5,753	458	1,029	4,656	50	13
Seattle	1,746	211	1,957	396	917	569	71	33
Total (note a)	76,823	9,650	86,473	13,899	39,824	32,521	3,502	313

a/There is a difference of 3,586 claims between the total claims and reconsiderations received by HUD, and the total claims determined, in process, or awaiting processing by HUD. The difference is irreconcilable. A HUD official stated that it is attributable to periodic inventory adjustments to certain, but not all, of the processing statistics.

The following table shows the status of claims received by the Chicago area office from about April 1975 through February 17, 1977. The Chicago area office is one of several area or insuring offices within the Chicago region. It should be noted from the table that only 18.9 percent of the claims received by the Chicago area office have passed eligibility and validity tests and have been accepted for reimbursement. This statistic, however, is comparable to the 18.1 percent of claims received nationwide (76,823) which were determined to be valid (13,899).

Status of claims	Number	Percent
Valid (acceptable for reimbursement)	2,508	18.9
Invalid	6,611	49.9
Ineligible	3,920	29.6
Eligible and in process	177	1.4
Awaiting processing	29	.2
Total	13,245	100.0

From April 1975 through January 1977, HUD made 12,173 section 518(b) payments to homeowners amounting to about $10.9 million. In some cases, two or more payments may relate to one claim. Total cost of the program since its inception in 1970 through January 1977 was about $18.5 million with 22,124 payments having been made. A breakdown of program payments by HUD regional or area offices was not available.

Also, requested statistics on the number of claims modified (accepted in part) were not available at either the Chicago area office or HUD headquarters. A Chicago area

office official did advise us, however, that most claims determined to be valid were only done so partially.

SCOPE OF REVIEW

Our review was conducted at HUD headquarters in Washington, D.C., and its regional and area offices in Chicago, Illinois. Section 518(b) statistical data was obtained on a national basis as well as for the two Chicago offices. We studied legislation incidental to the program and obtained the criteria and procedures HUD uses to carry out the program. To test these criteria and procedures, several samples of homeowner claims were selected for detailed review. Although not specifically requested to do so, we also reviewed the accuracy of section 518(b) homeowner reimbursements.

CHAPTER 2

ACTIONS NEEDED TO INSURE EQUITABLE TREATMENT TO HOMEOWNERS SUBMITTING CLAIMS UNDER SECTION 518(b)

Homeowners in the Chicago area who appeal their rejected section 518(b) claims stand a good chance of having the rejections overturned. Of the homeowners who have done so and whose appeals have been processed, about 45 percent have had their claims either wholly or partially approved. A look at why so many rejected claims were subsequently found to be valid disclosed that (1) the criteria used in evaluating claims have been weak and not very definitive and (2) the Chicago area office applied timeframe criteria deemed inappropriate by HUD headquarters or relied on the original Federal Housing Administration (FHA) appraisals in contravention of its own written instructions.

Not all homeowners in the Chicago area whose claims were rejected have appealed, even though some of these claims appear very similar in circumstances to those which have been appealed and later determined to be valid.

APPEAL STATISTICS

Of the 13,245 claims received by the Chicago area office from April 1975 through February 17, 1977, 6,611 of them were determine to be invalid. Of this number 1,677, or about 25 percent, had been resubmitted as of February 17, 1977, to the area office in the form of an appeal. Of the 1,411 that have been processed, 637, or 45 percent, were determined to be wholly or partially valid as shown in the following table.

Appeal status	Number	Percent
Valid	84	5.0
Partially valid	553	33.0
Invalid	774	46.1
Awaiting processing	266	15.9
Total	1,677	100.0

NEED FOR BETTER CRITERIA IN EVALUATING THE VALIDITY OF CLAIMS

Our review indicated that the large number of successful appeals is occurring because the criteria used in evaluating claims are vague in terms of defining (1) what constitutes an eligible defect or (2) how an inspector is to assure himself that the defect existed at the time of insurance commitment.

We reviewed 47 claims appealed to the Chicago area office that have been determined to be either wholly or partially valid and for which reimbursement vouchers had been prepared at the time of our review. Thirty-eight of these claims were determined valid by the area office. (Those determined to be partially valid also received regional and headquarters concurrence). Seven of the appealed claims were found to be invalid by the area office, but were overturned and declared valid at the regional and/or headquarters level. The remaining two claims had been appealed only because the homeowners disagreed with the amount HUD had agreed to reimburse them. Both of these claims were resolved by the area office in favor of the homeowners.

Our review of the 47 claims and the determinations the Chicago area office made disclosed, in part, that (1) structural defects have not been adequately defined, (2) there has been too much reliance placed on original FHA appraisals, and (3) claims were being both rejected and accepted primarily on the basis of fixed, time-limit criteria with apparently little consideration being given to the other factors of each case. Each of these situations is discussed below.

Structural defects not adequately defined

The section 518(b) inspector is required to evaluate whether the claimed defect is a structural or major defect which creates a serious danger to the inhabitants' lives or safety. HUD guidance, however, was not specific as to what constitutes a serious defect. For example, descriptions of items listed in the HUD instructions as eligible for assistance were limted to: "worn-out" for roofs, "seriously defective" for heating systems, and "rotten" for porches and steps. From this guidance the inspector was to determine the acceptability of the claimed item as a structural or major defect.

From our sample of reconsidered claims, we found many instances where claims were rejected by inspectors because, in their judgment, the defects were not structural or otherwise serious enough to endanger the inhabitants' lives

or safety but were subsequently determined to be valid during the appeal process. The two following examples illustrate the subjectivity of the decisions which were reached.

--A homeowner submitted a claim for replacing the boiler in his home. The section 518(b) inspector rejected the claim on the basis that a boiler is not a structural item. The homeowner appealed and the home was reinspected. The second inspector recommended that the homeowner be reimbursed because the boiler was not operational during the first heating season, and a contractor certified that the original boiler was beyond repair. The area office reconsideration committee concurred with the inspector's recommendation and the homeowner was reimbursed $1,495.

--A homeowner requested that repairs be made to the front porch of his home. The inspector determined that the repairs were eligible but was overruled by an area office reviewer who considered the repairs as a part of normal homeowner maintenance instead of being caused by a structural defect. The homeowner appealed. The home was not reinspected, and the area office reconsideration committee determined from the documentation in the file that the needed repairs were ineligible. From the same documentation, HUD headquarters determined that the item was eligible. Estimated cost to repair the porch was $200.

Inappropriate reliance on original FHA appraisals

Before a mortgage is insured under sections 203, 221, or 235 of the National Housing Act, an FHA appraisal/inspection is made to estimate the value of the property and the feasibility of insuring the loan. Another purpose of the appraisal is to determine if repairs, alterations, or additions to the property are necessary to insure protection of the Government's interest in the transaction.

Regarding the FHA appraisal/inspection, a 1970 report by the Senate Committee on Banking and Currency, which accompanied Senate bill 4368 (the section 518(b) legislation), stated that:

> "Information received by the Committee indicates that some FHA appraisers have allowed blatantly defective homes to be sold to lower income families under the 235 program. * * * The Committee feels that HUD should bear the burden of correcting these defects or compensating the owner for

them where HUD employees or agents have made an inadequate appraisal and inspection."

In line with the above statement, Chicago area office guidance to its section 518(b) inspectors directed them not to attempt to defend the original FHA appraisal but to be fair and objective, and resolve serious doubts in favor of the homeowners.

Nevertheless, 10 of the 47 reconsidered claims we looked at were rejected on the basis that the original appraisal/inspection had not disclosed the defect. For 6 of the 10 claims, area office reviewers had rejected the claims on this basis even though inspectors had earlier determined that the claims should be declared valid.

The following are examples of claims rejected on the basis of FHA appraisal reports which did not indicate the existence of the defect at the time of the commitment for mortgage insurance.

--A homeowner replaced the heating system in his home about 1 year after moving in. The inspector, after reviewing the homeowner's application for assistance, determined that it was eligible and valid and that it should be paid. An area office reviewer, however, rejected the claim because the original FHA appraisal report indicated that the heating system was acceptable. The homeowner appealed and the home was reinspected. The inspector recommended that the claimed defect be found eligible, and the area office reconsideration committee concurred with the inspector's recommendation. The amount approved for payment to the homeowner was $1,118.

--A homeowner had to repair the furnace in his home during the first year of occupancy and then replaced it about 1 year from the purchase date. The inspector determined that the furnace replacement was ineligible for reimbursement because it was working at the time of appraisal, according to the FHA appraisal report. The homeowner appealed the claim, and although the home was not reinspected, the area office reconsideration committee found the homeowner's claim eligible for reimbursement of $968 based on information in the claim file.

Inappropriate reliance on time-limit criteria

The Chicago area office adopted time-limit criteria against which the emergence or correction of a defect has

been applied in determining a claim's validity. Further, many of the claims we reviewed indicated that this criteria was applied without apparent consideration being given to other factors of each case.

At first, a 1-year limit from the date of commitment for mortgage insurance was used; later, a 2-year limit was adopted. To illustrate, in the initial months following the 1974 changes to the section 518(b) program, the Chicago area office was judging, as valid, claims for reimbursement relating to heating systems lasting only 1 year. Later, the criterion employed by the area office changed from 1 to 2 years because, according to an area office official, appealed claims involving heating systems replaced within 2 years were being declared valid at the regional and headquarters level. The area office subsequently adopted the 2-year criterion. We were advised by an area office official that a similar situation existed regarding defective roofs. We were also advised that once the heating system criterion had changed, no attempt was made to review all claims previously rejected under the more stringent criterion.

One effect of changing the time-limit criterion has been the treating of homeowners' claims inconsistently over the life of the program. Many claims rejected in the early stages of the program are similar in circumstance to claims accepted for compensation in the more recent stages after the criterion changed. Also, many homeowners who have appealed their claims rejected on the basis of the 1-year criterion have had their claims reconsidered valid using the newer criterion. Those who have not appealed their rejected claims will not be compensated.

An official at HUD headquarters told us that it is inappropriate to apply a steadfast time-limit criterion to all claims because each claim should be considered individually and upon its own merit.

A number of claims we looked at appear to have been initially rejected and then accepted on the basis of established time limits with little regard being given to any other circumstances of each case. In each case, the claim was originally rejected because the defect was corrected by the homeowner more than 1 year after the commitment for mortgage insurance, but was later determined to be valid after the area office criterion changed to 2 years.

The following are a couple of examples.

--A homeowner submitted a claim for replacing the roof on his home. An inspector found the claim invalid

because the roof was replaced 2 years after the homeowner moved in. The homeowner appealed, and the claim was determined to be valid by the area office reconsideration committee because the roof was replaced about 2 years after the homeowner moved in. The homeowner was reimbursed $735.

--Two homeowners submitted claims for the cost of replacing heating systems about 18 months after purchasing their homes. Inspectors found both claims invalid, and the homeowners appealed. The homes were reinspected during the appeal process, and the inspectors recommended that the claims be found valid. The area office reconsideration committee concurred with their recommendations because the repairs were made within 2 years of the commitment for mortgage insurance. The homeowners were reimbursed $1,300 and $1,121.

CLAIMS NOT APPEALED WHICH ARE SIMILAR TO CLAIMS RECONSIDERED VALID

Our review disclosed rejected claims which have not been appealed and in which the circumstances appear very similar to those surrounding many of the claims appealed and determined to be valid. We reviewed 25 such claims from our April 1975 sample. Twelve of the 25 appeared to have been rejected for the same types of reasons as the 47 discussed previously.

For example:

--A homeowner was notified that his claim for replacing the furnace in his home was ineligible for compensation because the furnace was acceptable at the time of the original appraisal. His claim was rejected even though it had been replaced within 1 year of the purchase date of the home, and the inspector had determined that the furnace was eligible. An area office reviewer rejected the claim on the basis that the furnace lasted 2 heating seasons--from December 3, 1968, to October 15, 1969.

--A homeowner was notified that his claim for replacing the heating system in his house was not eligible because it was acceptable at the time of the original appraisal. The inspector rejected the claim because the heating system lasted 1 heating season.

--A homeowner was notified that his claim for replacing the roof on his home was not eligible for reimbursement because the roof was acceptable at the time of

the original appraisal. The inspector rejected the claim because he considered the roof replacement as deferred maintenance. The roof was replaced less than 1 year after purchase of the home.

HOMEOWNERS NOT ALWAYS INFORMED OF RIGHT TO APPEAL

While homeowners have always had the right to appeal their disapproved claims, they have not always been informed of this right. In August 1975 an appeal clause that had been part of the Chicago area office's disapproval letter was deleted as a result of the development by HUD headquarters of a common acceptance/rejection letter designed to reduce the number of forms required in claims processing. The clause was reinstated by Chicago in April 1976.

During the 8 months in which the appeals clause was absent, the Chicago area office made no attempt to advise homeowners whose claims were disapproved of their right to appeal. Area office officials were of the opinion, however, that Chicago community organizations had adequately publicized the right to appeal rejected section 518(b) claims. They also believed that the 8-month deletion of the clause from the form letter had no effect on the number of appeals received by their office.

CONCLUSIONS

Homeowners in the Chicago area who have submitted section 518(b) claims have not been consistently treated in a fair and equitable manner. Because the criteria used are vague in terms of identifying what constitutes an eligible defect or how to determine that the defect existed at the time of insurance commitment, officials of the Chicago area office have been forced to exercise considerable judgment in evaluating claims.

As a result many of the claims initially rejected have been reevaluated during the appeal process and subsequently approved--not because there now exists a better set of criteria with which to make such decisions, but because the decisions are still very subjective ones, and there now appears to be a more liberalized acceptance by the Chicago area office of section 518(b) claims. This is evidenced by the successful appeal rate of 45 percent and is illustrated by many of the examples in this chapter. The lengthened time-limit criterion used by the Chicago area office also supports this contention.

Those homeowners who have appealed their rejected claims in the Chicago area have been quite successful, and

a question arises as to whether other homeowners who have not appealed may not have equally valid claims. Many of the rejected claims which have not been appealed appear very similar in circumstance to those successfully appealed.

RECOMMENDATIONS

To bring about more objective and consistent evaluation of a homeowner's claim for assistance under the section 518(b) program nationwide, the Secretary of HUD should direct

--the development of more clearly defined criteria as to what constitutes a serious defect, and

--that the guidance provided to inspectors for determining whether defects existed at the time of insurance commitment recognize the inappropriateness of relaying (1) solely on a fixed time limit without giving due regard to the other factors of each case or (2) on the original FHA appraisal.

In Chicago we recommend that the Secretary direct the area office to

--discontinue using a fixed, time-limit criterion to the exclusion of other pertinent factors and, rather than relying on original FHA appraisals, be fair and objective, and resolve serious doubts in favor of the homeowner in evaluating claims, and

--reevalute all claims it has rejected on the basis of such inappropriate criteria.

AGENCY COMMENTS AND OUR EVALUATION

In its letter of May 17, 1977, (see app. I) HUD disagreed that more clearly defined criteria as to what constitutes a serious defect need to be developed. HUD stated that the decision to give the benefit of any doubt to the homeowner required guidelines that were not too restrictive. It stated that claims determinations can only be made on a case-by-case basis and are strictly judgmental. HUD argued that its guidance cannot reasonably be revised to include all the varying situations that may have occurred and that it is not practicable nor desirable to put such limitations on the program.

We agree with HUD's statements that the program's guidance should not be too restrictive nor contain too many limitations. We do believe, however, that the guidance could have been, and should be, strengthened to reflect the actual experiences of the program in terms of what is an eligible

defect. This would help to reduce the number of incidences disclosed by our review where claimed defects, through subjective judgments, were being rejected initially because they were not felt to be structural or otherwise serious, but were later being accepted during the appeal process. It would add some objectivity to the determination process as well as an element of consistency (which has otherwise been lacking) within and among field offices as they consider the merits of each claim.

Regarding our recommendation that the guidance provided to inspectors recognize the inappropriateness of relying solely on a fixed time limit with little regard being given to anything else or on original FHA appraisals, HUD officials informally advised us on June 13, 1977, that such guidance is being drafted and will be provided to all HUD field offices.

HUD stated in its written comments that (1) the determination as to whether a defect existed at the time of insurance commitment is often a judgment factor and (2) it is extremely difficult to describe how this determination should be made. HUD said that a time criterion is helpful in giving the homeowner every benefit of the doubt if it can't positively be determined that the defect existed at the time of commitment. HUD indicated that the time factor is something it considers completely flexible and which must be used in conjunction with all circumstances of each case.

Regarding our recommendation that the Chicago area office should be directed to discontinue using a fixed, time-limit criterion to the exclusion of other factors and relying on original FHA appraisals in evaluating claims, HUD stated that since there never was a preset time criterion, the Chicago area office will be instructed to cease using one. HUD also stated that (1) the use of the original appraisal to substantiate the fact that a defect did not exist at the time of insurance commitment is unacceptable and (2) the practice was noticed at the time its staff was reviewing appeal cases. HUD said that many cases were returned so that this could be rectified.

HUD agreed to instruct the Chicago area office to reexamine all claims which were found invalid because of the inappropriate use of a time criterion or use of the original appraisal.

CHAPTER 3

VALID HOMEOWNER CLAIMS NOT FULLY REIMBURSED

Homeowner claims in the Chicago area are not being fully reimbursed under the section 518(b) program because, contrary to HUD procedures, average replacement costs from a "cost data book" are being used by the area office to determine such reimbursements. HUD guidelines state that the homeowner should be reimbursed for the actual costs incurred. Of 54 claims we reviewed which had been processed for payment, 21, or 39 percent, were found not to have been reimbursed in accordance with existing guidelines.

INCORRECT COMPENSATION OF CHICAGO HOMEOWNERS

Once a claim has been determined valid, section 518(b) procedures state that:

> "The homeowner will be reimbursed for all costs actually paid and found to be reimbursable notwithstanding the fact that the work could have been done at a lower cost."

The procedures also state that where the homeowner's claim is in excess of any reasonable amount proper for the work performed, the claim will be forwarded to HUD headquarters, together with the facts of the case, for determination. In addition, the procedures also specify that financing charges (including interest incurred by the homeowner in correcting an eligible defect) are a reimbursable cost under the program.

To test the HUD Chicago area office's implementation of the procedures, we reviewed 54 of the approximately 1,200 claims processed for payment as of July 1976. The 54 claims selected for review included (1) all 31 which, to that point in time, had been reconsidered valid and for which a voucher had been prepared, and (2) an additional 23 claims, which were randomly selected from those initially determined valid. The area office incorrectly determined the reimbursable amount for 21 of the 54 claims as shown below.

Type of error	Number	Total amount	Average
Underpayment	18	$5,278	$293
Overpayment	3	75	25

The overpayments were due to clerical errors made in computing the reimbursable amounts. The underpayments occurred because HUD area office personnel did not:

--Reimburse the actual costs incurred. The area office director provided written instructions to his personnel to use a cost data book to calculate the reimbursable amount for a given claim. The cost data book is furnished to members of the area office's underwriting staff for estimating replacement costs for building improvements when processing applications for mortgage insurance. The book lists the average price for replacing or repairing an item in the Chicago area. Because the book lists the average price, the actual cost incurred by the homeowner may be over or under that amount. The area office, however, considered this a reasonable method for determining reimbursable amounts. We were also advised by area office officials that claims for which full reimbursement had not been made were not forwarded to HUD headquarters as prescribed in the regulations because they believed the area office had authority to make the final decisions.

--Fully reimburse homeowners for finance charges for claims processed for payment after August 1975. Initially, HUD procedures did not allow homeowners to be reimbursed for any finance charges they incurred in correcting covered defects. In August 1975, however, HUD headquarters directed the Chicago area office to begin reimbursing finance charges.

The following two examples illustrate underpayments resulting from the Chicago area office's failure to follow prescribed procedures.

--One homeowner incurred a cost of $994 in replacing the heating system in his home ($915 for the heating unit plus $79 in finance charges). From the cost data book, the area office determined the reimbursable amount to be $609 including finance charges. The homeowner was reimbursed this amount, which is $385 less than the cost actually incurred.

--Another homeowner incurred a cost of $1,301 to replace the heating system in his home. Of the total amount, $1,020 was for the heating unit, and $281 was for finance charges. Again, using the cost data book, the area office determined the reimbursable amount to be $852, which is $449 less than the correct amount. The homeowner was reimbursed $852.

In July 1976 we brought the 18 underpayments disclosed by our review to the attention of Chicago area office officials. They acknowledged that underpayments had occurred and agreed to further reimburse all the claimants except one who had been underpaid only by an insignificant amount ($9.57). As of June 24, 1977, 12 of the homeowners had been paid the additional amounts, and vouchers for payment had been prepared for the remaining 5.

In July 1976 Chicago area office officials said that, as a result of our review, they are forwarding claims to HUD headquarters when the amount of reimbursement is in question. They also indicated a willingness to review the accuracy of all claims processed by their office to date, provided that sufficient staff is made available for this purpose by HUD headquarters.

CONCLUSIONS

The Chicago area office has not always followed prescribed procedures in reimbursing homeowners for costs incurred in correcting covered section 518(b) defects. A substantial percentage of claims exist where total actual costs (including finance charges) incurred by homeowners have not been reimbursed. Further, until recently, the area office had not forwarded claims to HUD headquarters for determination where there was some question as to the reasonableness of the costs incurred by the homeowner.

If HUD believes that its current procedures authorizing reimbursement on the basis of costs actually incurred is the most appropriate approach, such procedures should be implemented in a uniform and consistent manner by the Chicago area office.

RECOMMENDATIONS

The Secretary of HUD should direct the Chicago area office to pay all future section 518(b) claims in accordance with established procedures and reevaluate all claims paid to date in terms of such procedures. Also, because of our findings in Chicago, the Secretary should assure herself that other HUD field offices are making 518(b) payments in accordance with established procedures.

AGENCY COMMENTS

In its comments on this report, HUD agreed that prescribed procedures for fully reimbursing homeowners had not always been followed. HUD concurred that the Chicago area office should be directed to pay all future claims in

accordance with established procedures and that all claims previously paid should be reevaluated to assure that the reimbursement was an equitable one. Although HUD expects such a reevaluation to take a substantial length of time to complete with the present staff, it said that supplemental vouchers will be issued to any homeowners who were previously reimbursed less than the amount they actually paid.

HUD also stated that a notice will be prepared relative to the problem of section 518(b) reimbursements and that it will be distributed to all field offices.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

May 17, 1977

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

IN REPLY REFER TO:

Mr. Henry Eschwege
Director, Community and Economic
Development Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

Your letter of February 11, 1977, addressed to the Secretary of Housing and Urban Development transmitting a proposed report to the Congress entitled: "The Need to More Fairly Treat Homeowner Claims for Defects in Existing Insured Homes," has been referred to me for reply.

I will answer the recommendations in the order that they were presented.

Recommendation No. 1: To insure a more objective and consistent evaluation of a homeowner's claim for assistance under the Section 518(b) Program, the Secretary of HUD should direct the development of more clearly defined criteria as to what constitutes a serious defect.

[See GAO note, p. 25.]

Reply:

The statute is very specific and restrictive and, consequently, implementing instructions were very difficult to develop. The pros and cons of the specificity of the guidelines were discussed at great length, and on many occasions, during the development of the operating instructions. The decision to give the benefit of any doubt to the homeowner required guidelines that were not too restrictive. For example, a defect of a rotted porch raises the question to what degree was the porch rotted at the time of the appraisal so as to create a threat to the life or safety of the occupant.

A porch in such a condition, if the house were appraised in 1968 or 1969, would not have still been in existence in 1975 when the 518(b) inspection may have been performed. Similarly in the case of a worn-out roof, if the roof were in such a condition in 1968, when finally inspected in 1975 there would have been nothing left to inspect. Therefore, it seems clear to us that such determinations can only be made on a case-by-case basis and are strictly judgmental.

The guidance in the Handbook offered as examples of what may be considered eligible defects, if all other criteria are met, cannot reasonably be revised to include all the varying situations that may have occurred. It is not practicable nor desirable to put such limitations on the program.

The determination as to whether the defect existed at the time of commitment is often a judgment factor. It is extremely difficult to describe how this determination should be made. A time criterion is helpful in giving the homeowner every benefit of the doubt, if the appraiser cannot positively verify that the defect existed at the time of the commitment.

The time factor is something that we consider completely flexible. For example, in the case of a claim for a defective furnace replaced three years after the appraisal, the homeowner may state the furnace was inoperable most of the time and provide repair bills, or other evidence, to document this fact. The homeowner also may state that due to the lack of funds and the inability to obtain a loan it was necessary to "make do" until such time as he could afford to replace the furnace. To deny such a claim, even though it was three years after the appraisal when the furnace was actually replaced, would be unfair and would not give the benefit of doubt to the homeowner.

Recommendation No. 2: The Secretary should direct the Chicago Area Office to

--discontinue the use of inappropriate criteria currently being used in evaluating claims such as (1) the use of a time limitation and (2) reliance on original FHA appraisals, and

--consider the need to reevaluate all claims rejected on the basis of such inappropriate criteria.

APPENDIX I

Reply:

We addressed the use of a time limitation in the response to the first recommendation. Since there was never a preset time criterion, we will instruct the office to cease using one.

The use of the original appraisal to substantiate the fact that the defect was not apparent at that time is unacceptable. This practice was noticed at the time that our staff was reviewing the appeal cases. Many cases were returned so that this could be rectified.

We agree that the most equitable solution would be to reevaluate all the claims rejected on this basis. Accordingly, we will instruct the Chicago Area Office to reexamine all claims which were found invalid because of an arbitrary time criterion or use of the original appraisal.

Recommendation No. 3: The Secretary of HUD should direct the Chicago Area Office to pay all future Section 518(b) claims in accordance with established procedures and reevaluate all claims paid to date in terms of such procedures. Also, because of our findings in Chicago, the Secretary should assure herself that other HUD field offices are making 518(b) payments in accordance with established procedures.

Reply:

We agree that the prescribed procedures for fully reimbursing homeowners for costs incurred in correcting 518(b) defects were not always followed. This was brought to the attention of the office on the occasions of our program reviews and during the time of our review of appeal cases.

We concur that the Chicago Area Office should be directed to pay all future Section 518(b) claims in accordance with established procedures. The homeowners should be fully reimbursed for the amount expended, rather than the amount derived from the cost data book, except where it is documented that an improvement was made to the equipment such as the installation of central air conditioning where none existed previously. We agree that all such cases should be reevaluated to assure that the reimbursement was an equitable one. The performance of a reevaluation of all the claims processed to date will require a substantial length of time to complete with the present staff.

APPENDIX I

An examination of the vouchers issued for reimbursement payments will be performed. In any case that the issued voucher is less than the amount actually paid by the homeowner a supplemental voucher will be issued so that the homeowner will be fully reimbursed.

A Notice will be prepared relative to the problem of 518(b) reimbursement and will be distributed to all the field offices.

Sincerely,

Lawrence B. Simons
Assistant Secretary

GAO note: Deletion relates to recommendation in the draft report which has been revised in the final report.

APPENDIX II

PRINCIPAL HUD OFFICIALS

RESPONSIBLE FOR ADMINISTERING

ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
SECRETARY OF HOUSING AND URBAN DEVELOPMENT:		
Patricia R. Harris	Feb. 1977	Present
Carla A. Hills	Mar. 1975	Jan. 1977
James T. Lynn	Feb. 1973	Feb. 1975
George W. Romney	Jan. 1969	Feb. 1973
ASSISTANT SECRETARY FOR HOUSING-FEDERAL HOUSING COMMISSIONER (note a):		
Lawrence B. Simons	Mar. 1977	Present
John T. Howley (acting)	Dec. 1976	Mar. 1977
James L. Young	June 1976	Dec. 1976
ASSISTANT SECRETARY FOR HOUSING PRODUCTION AND MORTGAGE CREDIT-FHA COMMISSIONER (note a):		
David S. Cook	Aug. 1975	June 1976
David M. DeWilde (acting)	Nov. 1974	Aug. 1975
Sheldon B. Lubar	July 1973	Nov. 1974
Woodward Kingman (acting)	Jan. 1973	July 1973
Eugene A. Gulledge	Oct. 1969	Jan. 1973

a/On June 14, 1976, HUD combined the functions of the Assistant Secretary for Housing Production and Mortgage Credit-FHA Commissioner and the Assistant Secretary for Housing Management under a single Office of Assistant Secretary for Housing-Federal Housing Commissioner.