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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Honorable Donald W. Riegle, Jr. United States Senate

Improving The Process For Allocating Loan Management Set-Aside Funds To Multifamily Housing Projects

The Loan Management Set-aside Program, administered by the Department of Housing and Urban Development (HUD), is designed to help maintain the financial viability of multifamily housing projects experiencing cash-flow problems. Demand for program assistance far exceeded available funds in both fiscal years 1983 and 1984.

In this report, GAO

--identifies the process HUD used to allocate program funds in fiscal years 1983 and 1984,

--discusses four areas in the allocation process that need to be strengthened, and

--evaluates HUD's policy that limits the use of program funds for projects with mortgages held by HUD.

GAO makes recommendations to improve HUD's process for allocating limited program funds to better ensure that the most deserving multifamily housing projects receive assistance.

GAO/RCED-85-29
NOVEMBER 16, 1984

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RESOURCES, COMMUNITY,
AND ECONOMIC DEVELOPMENT
DIVISION

B-215961

The Honorable Donald W. Riegle, Jr.
United States Senate

Dear Senator Riegle:

As requested in your letter of August 15, 1983, this report evaluates the Department of Housing and Urban Development's (HUD's) process for allocating Loan Management Set-aside Program funds and its policy for applying these funds to multifamily projects with mortgages held by HUD.

We found that HUD headquarters can improve the allocation of program funds. We believe the recommendations included in this report will better ensure that the most deserving projects receive program assistance. Improving the allocation process is particularly important when requests for assistance are numerous and available funds limited, as was the case in fiscal years 1983 and 1984.

As agreed with your office, we are also sending copies of this report to the appropriate House and Senate committees; the Secretary of Housing and Urban Development; the Director, Office of Management and Budget; and other interested parties.

Sincerely yours,

Ralph Carlone for

J. Dexter Peach
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE HONORABLE
DONALD W. RIEGLE, JR.
UNITED STATES SENATE

IMPROVING THE PROCESS FOR ALLOCATING LOAN MANAGEMENT SET-ASIDE FUNDS TO MULTIFAMILY HOUSING PROJECTS

D I G E S T

The Loan Management Set-aside (LMSA) Program is administered by the Department of Housing and Urban Development (HUD) to help maintain the financial viability of multifamily housing projects with cash-flow problems. The program provides rent subsidies--generally the difference between a unit's rent and 30 percent of a tenant's income--to specific project units. The subsidy allows owners, in essence, to raise rents to meet operating expenses with the aim of stabilizing a project's financial condition to prevent financial default and hence a claim on HUD's multifamily mortgage insurance fund. (See p. 1.)

The program is available to both insured and held projects. An insured project is one where HUD insures the mortgage made by a private lender. A held project generally is one where HUD serves as the lender by holding the mortgage on a previously defaulted insured mortgage.

At the request of Senator Riegle, GAO reviewed the process used by HUD to allocate LMSA funds in fiscal years 1983 and 1984, and HUD's basis for restricting the use of LMSA funds for held projects. GAO conducted its review at HUD headquarters and five field offices between November 1983 and May 1984. (See pp. 2-4.)

HUD'S ALLOCATION PROCESS CAN BE STRENGTHENED

The process HUD used to allocate program funds in fiscal years 1983 and 1984 consisted of three stages. First, headquarters issued a memorandum containing instructions to field offices on the factors to consider in identifying projects that would benefit from LMSA funds. Second, field offices identified possible projects and submitted statistical

GAO/RCED-85-29
NOVEMBER 16, 1984

and/or narrative information on funding needs to headquarters. Third, headquarters used the field data to select projects to receive LMSA funds. In both fiscal years, the amount of funds requested by the field offices was about three times that available. (See p. 5 and app. II.)

GAO identified four areas where HUD can strengthen its allocation process. First, HUD needs to provide clearer instructions to its field offices on how to identify projects with the greatest potential for mortgage default. In 1983, headquarters instructed the field to use a computer-based system to identify projects in imminent danger of default, but officials in four of the five HUD field offices GAO visited considered the system unsatisfactory because it had outdated and missing financial data. Recognizing the system's shortcomings, headquarters in 1984 no longer required its use but left the approach for identifying projects in imminent danger of default to the discretion of field offices and did not require the field offices to describe the process used. As a result, headquarters did not have information with which to evaluate the criterion of imminent danger of default. (See pp. 7-12.)

Second, HUD needs to provide guidance to its field offices on how to compute the number of units and the related amount of LMSA assistance needed for a project. Projects' chances for receiving assistance were less in some field offices than others because the field used different criteria in computing units and related LMSA assistance. Headquarters did not explain to the field offices how to compute these two figures, and the five field offices GAO visited varied in making these computations. For example, field offices applied different percentages--ranging from 70 to 100 percent--to units' rents to calculate the amount of funds requested. The requested number of units and funds were inputs to computing the cost-benefit ratio--the second most heavily weighted selection criterion in 1983 and 1984. Because headquarters was unaware of the differences in computing units and funds needed, it could not adjust for the differences when evaluating the cost-benefit criterion among projects. (See pp. 12-14.)

Third, HUD needs to require that its field offices document how LMSA funds would ensure projects' long-term viability, especially how LMSA funds would solve cash-flow problems. Program regulations require reasonable assurance that projects' financial problems would be resolved with LMSA funds. GAO reviewed data from three field offices on 24 projects submitted and funded in 1983 (the two other offices received no funds) and found that the information on each project did not specify the amount of the project's cash shortage nor did it relate how the amount of funds requested would resolve the cash deficit. Thus headquarters did not have documentation with which to assess the long-term viability of projects. (See pp. 14-16.)

Fourth, HUD needs to clarify how tenant income, which impacts on the amount of rent the project owner can charge and, consequently, on project viability, should be considered in identifying projects and documented when submitting funding proposals to headquarters. Tenant income was not a factor that field offices were directed to consider in fiscal years 1983 and 1984. Consequently, headquarters was not in a position to consider tenant income and its relationship to rent in its selection of the most deserving projects. The income level of tenants affects the amount an owner can raise rents to cover operating expenses. Insufficient rental income can force a project into a deficit cash-flow position that threatens its long-term viability. (See pp. 16-17.)

Besides affecting project viability, tenant income also affects decisions involving (1) promoting the well-being of low-income tenants and (2) allocating funds to the projects selected. The greater a low-income tenant's rent-to-income ratio, the greater, generally, is the tenant's need for program assistance. Providing program funds for units housing the more needy tenants promotes the well-being of low-income persons. (See pp. 17-18.)

GAO found that program funds allocated for projects often exceeded the amount of funds actually paid to project owners. This situation occurred in part because tenant income was not considered in estimating and reserving funds for a project. Instead, funds were reserved for projects on the basis of a fixed percentage of unit rent. GAO found that through February 1984, over $1.2 million in unused funds had accumulated on 30 projects funded in three field offices during fiscal years 1982 and 1983.

When funds are limited and the amount of funds reserved for projects is greater than the amount used, other needy projects may unnecessarily go unassisted. Recognizing that some projects may have more funds available than needed, HUD is attempting to determine if it has the legal and budgetary authority to transfer funds from projects with excess reserves to other projects needing additional funds. (See pp. 18-20.)

USE OF PROGRAM FUNDS FOR HELD PROJECTS

HUD has not developed an approach to measure when it is cost-effective to use LMSA funds for held rather than insured projects. According to HUD regulations, program funds can be used on either insured or held projects with immediate or potentially serious financial problems that would result in claims on the Department's multifamily mortgage insurance fund. HUD uses the fund to pay off the mortgage expense on a defaulted insured project, and to cover expenses such as property taxes when the owner of a held project does not meet his financial obligations. HUD's regulations, however, do not specify the circumstances under which it is appropriate to use program funds on one type of project versus the other. (See p. 22.)

In 1983, headquarters targeted program funds for insured projects since generally they, in comparison to held projects, result in a larger claim on HUD's insurance fund. In 1984, headquarters instructed the field to consider held projects for funding if, among other things, it could be demonstrated that using program funds was cost-effective. Headquarters did not explain, however, how to evaluate cost-effectiveness for held projects. (See pp. 22-24.)

GAO believes that HUD needs to clarify when it is cost-effective to use program funds for held projects. HUD statistics showed that for fiscal year 1983 the impact on the mortgage insurance fund is about three times as great when a default occurs on an insured project in comparison to when a project is held, goes into foreclosure, and becomes owned by HUD. Thus, if HUD intends to view cost-effectiveness in the context of drawdowns to the mortgage insurance fund, then the greatest benefit would generally occur by applying funds to insured rather than held projects.

GAO believes cost-effectiveness also can be viewed beyond the impact on the mortgage insurance fund to consider other costs the government would incur if a held project becomes financially more troubled and is eventually sold by HUD. When HUD sells a project, HUD often attaches a subsidy, similar to LMSA assistance, to the project's units to provide greater assurance that the project, after sale, will continue to serve lower income tenants. GAO compared the average per unit fiscal year 1983 subsidy attached to projects when sold--$4,409--with the average per unit 1983 LMSA subsidy--$2,953. Accordingly, if a held project can be made financially healthy by applying LMSA funds, then HUD may avoid the higher subsidy associated with selling a project as well as the additional insurance fund costs associated with foreclosure and maintaining the project until it is sold.

RECOMMENDATIONS TO THE SECRETARY OF HUD

GAO recommends that the Secretary of HUD develop specific procedures for identifying and selecting projects to be funded and that the procedures be incorporated into the LMSA handbook and the Code of Federal Regulations. These procedures should

--explain to field offices how factors used to identify and select projects to receive LMSA funds (for example, imminent danger of default and number of units for which assistance is being requested) are to be determined, documented, and evaluated;

--state clearly the extent to which tenants' financial situation (measured in terms of rent-to-income ratio) should be (1) considered by field offices when identifying projects and (2) documented when submitting funding proposals to headquarters;

--instruct the field offices to document clearly for headquarters that (1) projects' financial problems are traceable to inadequate cash flow and (2) the infusion of program funds is expected to provide a reasonable assurance of long-term project viability; and

--contain a methodology to measure and compare the cost-effectiveness of using LMSA funds for insured versus held projects. For a held project, the methodology should explain whether cost-effectiveness should be measured only in the context of minimizing expenditures from HUD's multifamily insurance fund or in the broader context of overall costs avoided by the government if a held project is likely to go into foreclosure and eventually be sold with subsidies for lower income tenants. (See pp. 21 and 25.)

AGENCY COMMENTS

GAO did not request that HUD comment on this report.

Contents

ILLUSTRATIONS

ABBREVIATIONS

GAO	General Accounting Office
HUD	Department of Housing and Urban Development
LMSA	Loan Management Set-aside

CHAPTER 1

INTRODUCTION

LOAN MANAGEMENT SET-ASIDE PROGRAM

The Loan Management Set-aside (LMSA) Program was created in 1976 as a spin-off of Section 8 of the Housing and Community Development Act of 1974. This Department of Housing and Urban Development (HUD) program is designed to help maintain the financial viability of multifamily housing projects--generally those with five or more units--experiencing cash-flow problems. These troubled projects often have problems common to many lower income multifamily housing projects including escalating operating and maintenance expenses, poor management, and the inability of low-income tenants to pay their rent. This causes owners of these projects, in some cases, to default on their mortgages, resulting in HUD having to pay off this mortgage expense from its multifamily mortgage insurance fund.[1] HUD allocates LMSA funds for specific units within multifamily projects to meet two program goals: (1) to reduce government outlays from HUD's insurance fund and (2) to ensure the continued availability of units for lower income families (those whose income does not exceed 80 percent of the median income for the area).

Reducing government outlays related to multifamily projects requires controlling drawdowns from HUD's insurance fund. For multifamily projects, HUD either insures the mortgage loan made by a private lending institution (insured project) or serves as the lender by holding the mortgage, generally on a previously defaulted loan (held project). As of September 30, 1983, there were 15,346 insured and 1,735 held multifamily projects. The largest single drawdown on the insurance fund occurs when the owner of an insured project defaults on the mortgage payment. HUD then normally pays 99 percent of the outstanding mortgage balance plus accrued interest, and the mortgage becomes assigned or held by HUD. When a held project continues to experience financial difficulties, the insurance fund covers other expenses including unpaid property taxes and administrative and legal costs associated with foreclosure actions and additional expenses associated with maintaining a project until it is sold. HUD statistics show that, for 254 multifamily projects

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[1]Two primary insurance funds--the General Insurance Fund established in 1965 and the Special Risk Insurance Fund established in 1968--insure multifamily projects. The federal government has appropriated over $3.3 billion through fiscal year 1983 to cover the difference between revenues paid into the funds and expenses paid out. For purposes of this report, the two funds are collectively referred to as "the insurance fund."

sold in fiscal year 1983, a total of about $480 million was drawn down from the insurance fund. HUD's insurance fund drawdown at the time these projects were assigned was about $356 million (74 percent), while an additional expense of about $124 million (26 percent) was paid from the insurance fund for expenses associated with servicing the held mortgages, foreclosures, and operation and maintenance of the projects during HUD's ownership.

To ensure the continued availability of units for lower income families as well as to reduce government outlays, HUD subsidizes tenant rents. Under the program, a project owner is generally entitled to receive the difference between the unit's rent and 30 percent of a tenant's income. By subsidizing this difference, the program allows owners to raise rents to meet operating expenses with the objective of stabilizing a project's financial condition to avoid a drawdown on the insurance fund. Also, allocating program funds for units currently housing lower income tenants helps to ensure the continued availability of units to such tenants because they can better afford rents limited to 30 percent of their income.

The LMSA program is administered by the Office of Multifamily Housing Management, 10 regional offices, and other field offices located throughout the country. Field offices have staff members within the Loan Management Branch, including supervisors, technical support specialists, and loan servicers. Loan servicers and their immediate supervisors carry out specific oversight functions, including monitoring the financial and physical condition of multifamily projects.

During fiscal years 1976-79, LMSA funds were allocated to about 180,000 units. No funds were budgeted for the program in fiscal years 1980-82. In fiscal year 1983, HUD allocated funds for 6,579 units, and HUD plans to allocate funds for about 5,000 units in fiscal year 1984.

OBJECTIVES, SCOPE, AND METHODOLOGY

On August 15, 1983, Senator Riegle requested that we review HUD's current policy regarding the use of LMSA funds for multifamily projects with mortgages held by HUD. This request was prompted by the apparent lack of subsidy for held projects compared with the availability of subsidy for projects insured and owned by HUD. More specifically, he asked us to assess the degree to which (1) the benefits of local ownership are lost, (2) underinvestment in project repair and maintenance is exacerbated, and (3) the costs to the federal government through foreclosure and property disposition are greater when LMSA funds are not used for held projects. Because limited data precluded our adequately evaluating the first two issues, we agreed with the Senator's office to

--identify the LMSA allocation process used in fiscal years 1983 and 1984,

--determine if the allocation process could be improved, and

--evaluate HUD's policy that limits the use of LMSA funds to held projects without considering the foreclosure and property disposition costs avoided when LMSA stabilizes held projects.

To identify the LMSA allocation process used in 1983 and 1984 and to determine whether it could be improved, we first reviewed guidance issued by HUD headquarters to its field offices and discussed this guidance with the Director and other officials in the Office of Multifamily Housing Management and with Loan Management Branch officials in the five field offices to determine if the guidance was sufficiently clear and consistently applied. Second, we reviewed data on all 51 projects submitted for funding by the five field offices in fiscal year 1983 to assess consistency and adherence to the guidance and to determine if clearer procedures were needed to better ensure that headquarters selected the most deserving projects. Third, we examined the criteria used by HUD headquarters in making the final selection of projects to determine if the criteria supported program objectives. Fourth, we reviewed various agency documents citing the program goals and compared, for consistency, these goals with the selection criteria. Because the field offices had not completed their fiscal year 1984 project submissions at the time we completed our field work, we reviewed preliminary project data being prepared by the field offices in 1984.

In carrying out our review objectives we also selectively examined files for projects that received LMSA funds. We reviewed loan management contracts between HUD and project owners, financial data, physical inspection reports, management review reports, and various other documents to gain a better understanding of program operations. Further, for some projects in the Cleveland, Detroit, and Philadelphia field offices, we compared reserved LMSA assistance with actual expenditures to determine how well HUD estimated the amount of LMSA funds needed for each project. HUD's Chicago and Philadelphia regional accounting divisions provided some of this data.

To evaluate HUD's policy for held projects, we interviewed Loan Management Branch staff to determine their views on the cost-effectiveness of using LMSA funds for held projects. In addition, we identified costs avoided if a held project is stabilized after LMSA funds are applied to the project. We also compared the financial status, as of November 1983, of 132 insured and held projects in the Detroit office that were funded between fiscal years 1976 and 1983 to see whether LMSA funds were more beneficial in maintaining insured or held projects' long-term viability. We selected the Detroit office because it had a sufficiently large portfolio of projects that received funds in the program's early years to enable us to track the financial condition of projects after receiving LMSA funds. Since our comparison was restricted to the Detroit office, we cannot project the results to HUD's inventory of projects that have received LMSA funds.

We did not try to evaluate whether the five field offices we visited correctly identified the most needy projects, nor did we attempt to compile our own list of the most deserving projects from among all the multifamily projects in these offices. To do so would have required us to perform a financial analysis and review extensive documentation for each project. (A field office is often responsible for over 300 projects.) Also, we did not determine if headquarters made the most appropriate selection of projects in fiscal years 1983 and 1984 from among the nearly 600 projects submitted by the field offices in those 2 years. We could not use the information submitted from the field to headquarters to make this determination because it was not sufficiently detailed, and field offices computed key information differently. For us to determine if headquarters actually selected the most appropriate projects, consistent with program objectives and regulations, would have required us to obtain and analyze additional data for the nearly 600 projects submitted from the field. This analysis was outside the scope of this review.

We conducted work at HUD headquarters and field offices in Boston, Massachusetts; Cleveland, Ohio; Detroit and Grand Rapids, Michigan; and Philadelphia, Pennsylvania. We selected the Detroit office because it received the third largest amount of LMSA funds in fiscal year 1983 and was one of only two offices to receive funds in 1983 for a held project. The Cleveland and Grand Rapids offices were selected because 71 percent and 100 percent, respectively, of the projects they submitted for funding in fiscal year 1983 were approved. The Philadelphia and Boston offices were selected to obtain a different perspective since none of the projects they submitted in fiscal year 1983 were approved.

We performed our review in accordance with generally accepted government auditing standards with the exception of obtaining official agency comments. As requested by your office, we waived this requirement. Our audit work was conducted between November 1983 and May 1984.

CHAPTER 2

IMPROVEMENTS CAN BE MADE

IN THE LMSA ALLOCATION PROCESS

The demand for LMSA funding assistance to help maintain the financial viability of multifamily housing projects far exceeded available funds. For example, in fiscal year 1983, HUD received funding requests of about $51.6 million for over 16,600 units in 231 projects but could only provide assistance of about $19.5 million to about 6,600 units in 118 projects. Similarly, the fiscal year 1984 requests exceeded available funds. About $59 million for nearly 20,000 units in 362 projects was sought, but only about $18 million for about 5,000 units was available.

Because funds are limited, it is critical that HUD establish procedures that better ensure allocation of available funds to the most needy projects. We found four areas in HUD's prioritization and selection process that we believe can be strengthened to better ensure that field offices identify and headquarters selects the most deserving projects for funding.

LMSA ALLOCATION PROCESS

HUD's LMSA allocation process in fiscal years 1983 and 1984 consisted of (1) HUD headquarters issuing instructions to its field offices on which factors to consider in identifying projects needing financial assistance, (2) the field offices identifying possible projects and submitting them to headquarters for consideration, and (3) headquarters reviewing the field data and selecting projects to be funded.

Headquarters instructed the field offices in memoranda dated May 12, 1983, and January 23, 1984, to identify projects in imminent danger of default and with financial problems caused by conditions beyond the owner's control. Additionally, the field was instructed to comply with Title 24, Part 886 of the Code of Federal Regulations, which states that LMSA funds be used for projects (1) whose major problems are traceable to inadequate cash flow and (2) when the infusion of funds should reasonably ensure long-term project viability. Further, the 1984 memorandum required adherence to the LMSA handbook, which contains procedures for administering the LMSA program. The handbook, however, does not reflect the fiscal years 1983 and 1984 prioritization and selection process.

In both fiscal years 1983 and 1984, the field offices were required to submit to headquarters statistical information on the projects they identified. In fiscal year 1983 only, the field offices were required to provide a computer-generated score indicating a project's vulnerability to default. Additionally, field offices were required to submit a project narrative, briefly describing the project's financial problem and its causes, an overall strategy for solving the problem, and an explanation of why LMSA funding was essential. Although the May 12, 1983, memorandum did not specifically state that the field offices were to identify only insured projects for funding consideration, HUD's Director, Office of Multifamily Housing Management, explained that the memorandum was intended to exclude held projects from consideration because a program goal is to protect the insurance fund, and the greatest drawdown to the fund occurs when an insured project defaults. In contrast, the 1984 memorandum specifically directed the field to consider held projects, although the memorandum stated that they would receive a lower funding priority than insured projects. In 1984 headquarters also instructed the field to prioritize projects submitted, but required no project narrative.

Because demand for LMSA funds exceeded those available in both 1983 and 1984, headquarters developed criteria to prioritize and select projects the field offices submitted. In 1983, headquarters evaluated each project according to three criteria--vulnerability to default, cost-benefit ratio, and owner's contribution--using a quartile scoring system. Projects that fully satisfied a criterion were placed in the criterion's fourth, or highest, quartile, while those that met a criterion to a lesser degree were assigned to the third, second, or first quartile. Headquarters applied a weight to each criterion to arrive at a composite score for each project. Headquarters ranked projects according to their composite score and selected those with the highest score for LMSA funding.

The field offices submitted 231 projects requesting about $51.6 million of assistance for over 16,600 units in fiscal year 1983. A total of 6,579 units in 118 projects (116 insured and 2 held projects) received funds with the total annual LMSA subsidy estimated at $19.5 million.

In fiscal year 1984, headquarters increased from three to four the number of criteria used to rank projects for selection. Two criteria--the cost-benefit ratio and owner's contribution--were similar to the 1983 criteria. Headquarters used two other criteria--occupancy rate and priority order of a project's need for LMSA funding as identified by the field--in place of the 1983 imminent danger of default criterion. Again, headquarters evaluated each project against each of the criteria and assigned the criteria a relative weight. A maximum of 100 points could be assigned to a project.

In fiscal year 1984, headquarters budgeted 5,000 units and $18 million for LMSA funding. The field offices requested about

$59 million for nearly 20,000 units in 362 projects (302 insured and 60 held). As of July 11, 1984, headquarters approved an annual LMSA subsidy of $12.5 million for 3,824 units in 225 insured projects. These units represent the lesser of the insured projects' vacant units or the number of requested units. All 225 insured projects received a minimum of 40 points in the allocation process. Headquarters tentatively approved $347,242 for 154 units in 12 "202" projects[2] but had still not decided how to allocate the remaining 1,022 units. (See app. II for more detail on the fiscal years 1983 and 1984 allocation process.)

AREAS NEEDING IMPROVEMENT IN THE LMSA ALLOCATION PROCESS

For HUD to better ensure that its field offices identify their most deserving projects to receive LMSA funds and that HUD headquarters selects the most deserving projects from among those submitted by the field offices in future fiscal years, we believe HUD needs to improve four areas of the allocation process.

We believe these improvements are necessary because we found, in reviewing HUD's allocation process in fiscal years 1983 and 1984, that HUD headquarters did not have uniformly developed, sufficiently detailed, or necessary information from the field offices to best ensure it selected the most deserving projects in accordance with program regulations. Specific weaknesses were: (1) missing and outdated financial data on projects, (2) different computations of the amount of program funds needed and the number of project units needing assistance, (3) insufficient documentation demonstrating how program funds would resolve a project's financial problems, and (4) no guidance to the field offices on if or how tenant income should be considered in identifying projects and submitting funding proposals to headquarters. We believe that HUD can improve its allocation process by providing the field offices with clearer instructions on the information it needs to prioritize and select projects for funding.

The following two charts illustrate the selection criteria used by headquarters in 1983 and 1984, the weights assigned to each criterion, how the criterion was determined, the shortcoming with each criterion, and the implication of the shortcoming for ranking and selecting projects. These shortcomings relate directly to the four weaknesses cited above and are included in the discussion on pages 10 through 20.

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[2]The section 202 program provides long-term direct loans to eligible private nonprofit sponsors to finance housing facilities for the elderly and handicapped. A "202" project is considered to be a held project.

Fiscal Year 1983 Project Selection Process

Criterion	Weight	How determined	Shortcoming	Implication of shortcoming on ranking and selecting projects
	(percent)			
Vulnerability to default	45	Risk analysis system.	Missing and outdated financial information and problems with risk analysis computer program.	Risk analysis system's shortcomings limit its usefulness in identifying projects with greatest financial need.
Cost-benefit ratio	35	Project's outstanding mortgage divided by the requested LMSA funds.	Requested funds computed differently by field offices, and differences not known by headquarters.	Computing requested funds differently can affect the cost-benefit ratios and thus the relative rankings of projects and number of projects selected.
				Headquarters unaware of extent of different approaches, and could not, therefore, adjust for the differences when making final selection of projects.
Owner's contribution	20	Owner's prior (last 2 years) and future (1 year) contribution divided by the requested LMSA funds.	Future contribution is not always a "hard" number.	Projects with high future contributions may have received a higher funding priority than appropriate.
			Does not relate owner's contribution to project's financial needs.	Project could be ranked high, but owner's contribution could be insufficient to make project financially healthy.
Total	100			

Fiscal Year 1984 Project Selection Process

Criterion	Weight (percent)	How determined	Shortcoming	Implication of shortcoming on ranking and selecting projects
Priority order of need	40	Discretion of field offices.	Assumes equal need for LMSA funding among field offices. Also, no guidance on how field was to determine priority.	Increases the possibility of selecting projects with a lesser need for LMSA funding.
Cost-benefit ratio	25	Project's outstanding mortgage divided by requested LMSA funds.	Requested funds computed differently by field offices and differences not known by headquarters.	Computing requested funds differently affects the cost-benefit ratios and thus the relative rankings of projects and number of projects selected. Headquarters unaware of extent of different approaches, and could not, therefore, adjust for the differences when making final selection of projects.
Occupancy rate	20	Field offices calculated rate based on project records.	Headquarters' assumption that higher occupancy meant less need for LMSA funding did not recognize tenant income levels.	Projects with low-income tenants may not have received appropriate LMSA funding consideration.
Owner's contribution	15	Owner's prior (last 2 years) contribution divided by requested LMSA units.	Does not relate owner's contribution to project's financial needs.	Project could be ranked high, but owner's contribution could be insufficient to make project financially healthy.
Total	100			

Clearer instructions needed to identify projects in imminent danger of default

In fiscal year 1983, HUD headquarters instructed the field to consider only projects in imminent danger of default for LMSA funding. Headquarters directed the field to use the numerical score generated by the risk analysis system[3] to identify these projects. The field, however, experienced problems--for example, missing and outdated information--with this system that limited the usefulness of the risk analysis score for identifying the most financially troubled projects. Headquarters assigned the greatest weight--45 percent--to the imminent danger of default criterion during the selection process. Ultimately, headquarters selected projects with the highest risk analysis scores for LMSA funding.

The financial data used for the risk analysis system comes from HUD's computerized Office of Loan Management System. Each field office inputs data to this system from projects' annual financial statements. We reported in January 1984[4] that the system had many data limitations and, consequently, questionable validity as an indicator of a project's condition. For example, our report pointed out that the financial data is often out of date and, consequently, does not accurately reflect a project's current condition.

Loan servicers and their supervisors in the field offices we visited agreed that the system had serious data limitations, such as noncurrent income and expense reports, that undermined the usefulness of the risk analysis system. Staff in the Philadelphia office said that financial data on projects is not entered routinely into the system and, consequently, because the data is not current, the system is not used. Loan management staff in the Detroit office said they tried to use the risk analysis system, but found it unacceptable because of missing and outdated financial data and improper functioning of the risk analysis computer program. Consequently, they submitted projects to headquarters for consideration in 1983 without risk analysis scores. At the subsequent request of HUD headquarters, Detroit manually computed these scores from records maintained in the field office and servicers' knowledge of their projects.

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[3]This system, developed in early 1982, assesses the overall condition of a project by combining computerized financial information with other data obtained from reports on a project's management and physical condition.

[4]Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management, (GAO/RCED-84-9, Jan. 10, 1984).

Because of similar data problems, the Grand Rapids and Cleveland offices also did not furnish headquarters with risk analysis scores. Grand Rapids officials said that they merely designated their projects as "severely troubled," and headquarters gave them a commensurate risk analysis rating, which put them in the highest quartile for this selection criterion. Likewise, the Loan Management Branch chief in Cleveland said that he had several telephone conversations with headquarters to explain why the Cleveland projects should be given high risk analysis scores.

Aside from the problems expressed by the field offices, the risk analysis score, weighted at 45 percent, may have been given more emphasis in the selection process than warranted. Headquarters, in the memorandum establishing the system, recognized that the risk analysis score may not always accurately reflect a project's condition. The memorandum stated that a high risk analysis score could be generated incorrectly if the data in the Office of Loan Management System were inaccurate, if a project were in initial occupancy, or when corrective actions (such as owner capital contributions or rent increases) were in process and the effects had not been reflected in the financial ratios or management review and physical inspection ratings.

In spite of the data problems and HUD's recognition that the risk analysis system may not always accurately reflect a project's condition, the importance of the risk analysis score was evident in the 1983 selection process. All projects submitted for funding that had a risk analysis score (either supplied by the field or assigned by headquarters) in the fourth (highest) quartile received LMSA funding, and 79 percent of those with risk analysis scores in the third quartile were also funded. Conversely, only 4 of the 49 projects that had risk analysis scores in the first (lowest) quartile received LMSA funding.

In fiscal year 1984, headquarters again directed the field to submit projects in imminent danger of default, but, according to a headquarters official, because of problems experienced with the risk analysis system, no mention was made of using the system to satisfy this criterion. The primary substitute criterion in 1984--assigned a weight of 40 points--was priority order of need. Headquarters required field offices to submit projects in priority order. Headquarters' guidance did not explain to the field offices how to determine priority, nor did headquarters require the field to describe the process used. Headquarters left the identification of priority need of projects to the discretion of the individual field offices. Our field work was completed before the final identification of projects; however, it appears from our conversations with loan servicers that they were planning to prioritize projects on the basis of their personal knowledge of their projects. While field offices may have accurately prioritized their projects, headquarters' system for assigning points to this criterion is not necessarily based on a correct assumption. Headquarters' system for assigning points to this criterion--giving 40, 30, 20, and 10 points, respectively, to the first four projects identified by each field office and 0 points to the fifth and subsequent projects--assumes that the projects in one field office have the same need for LMSA funds as those in another field office. In reality, it is possible for a project listed as third priority in one field office to be more needy and more deserving of program funds than is a project listed as first priority in another field office. Headquarters' allocation process does not allow for this possibility.

Instructions needed on how to compute the number of units and the amount of LMSA assistance requested

Neither the 1983 nor the 1984 memoranda explained how to determine the number of units in a project for which assistance should be requested--contract units--or how to compute the requested amount of annual funding--contract authority. Such computations were critical in ranking and selecting projects. Requested contract units were the basis for computing requested contract authority, which in turn was used to compute the cost-benefit ratio, the second most heavily weighted selection criterion in both fiscal years 1983 and 1984. The approaches the field offices used to calculate requested contract units and requested contract authority varied, but the field offices did not explain to headquarters the methods they employed. Consequently, headquarters was unaware of the extent of inconsistent approaches and, therefore, could not adjust for the differences when making the final selection of projects.

In 1983, for example, the Cleveland office requested assistance for all units in a project not already assisted. A Cleveland official said that since about 90 percent of the tenants in unassisted units are generally eligible, requesting assistance for all unassisted units saves time. Conversely, both the Detroit and Grand Rapids offices determined project unit requirements based on actual needs. In Grand Rapids, for example, loan servicers added the number of vacant units to the units where tenants had a high ratio of rent-to-income to determine project needs. For the 362 projects submitted in fiscal year 1984, assistance was requested for all unassisted units in about 54 percent of the projects, while funding requests for the remaining 46 percent were apparently based on perceived needs.

Field offices computed requested contract authority by multiplying the number of requested contract units by the LMSA subsidy per unit; however, the offices were not consistent in the percentage of rent that would be subsidized. For example, in 1984 Cleveland and Detroit computed requested contract authority based on 70 percent of rent, while Philadelphia and Boston used 100 percent. Detroit and Cleveland officials stated that they used the 70-percent figure because, according to the Housing and Community Development Act of 1981, LMSA funds are supposed to cover the difference between the rent and 30 percent of a tenant's income. Philadelphia and Boston used 100 percent because officials said tenants' incomes were very low, thus requiring a greater subsidy.

Consistency in the computation of requested contract authority is important in project selection. For example, in fiscal years 1983 and 1984, the cost-benefit ratio was weighted 35 and 25 percent, respectively, among the selection criteria. This ratio is computed by dividing a project's outstanding mortgage by the requested contract authority. Inconsistent computations of requested contract authority can significantly alter cost-benefit ratios, as illustrated by the following hypothetical cases.

Case 1: Assume a 100-unit project is being considered for LMSA assistance. Further, assume the project has an outstanding mortgage of $2 million, that all units rent for $300 a month, and that 60 units in the project already receive some form of rental assistance.

Consider a field office that computes requested contract units based on all unsubsidized units--in this case 40--and computes requested contract authority on the basis of 100 percent of rent. The requested contract authority based on this method would be $144,000 ($300 a month x 12 months x 40 units). The associated cost-benefit ratio would be approximately 14 to 1 ($2 million in outstanding mortgage divided by $144,000 in requested contract authority).

Case 2: Assume a similar project is being considered for program funding by another field office that requests assistance for all unsubsidized units--in this case 40--and computes requested contract authority based on 70 percent of rent. The requested contract authority is $100,800 ($210 a month x 12 months x 40 units), and the corresponding cost-benefit ratio is about 20 to 1 ($2 million in outstanding mortgage divided by $100,800 in requested contract authority).

These cases illustrate that differences in field office computations can result in wide variations in requested contract authority ($144,000 and $100,800) and cost-benefit ratios (14 and 20). In turn, these variations can affect both the number and actual selection of projects funded.

Need to submit documentation specifying how LMSA funds will resolve projects' financial problems

The documentation submitted from the field offices did not demonstrate how program funds would resolve projects' cash-flow problems and ensure projects' long-term viability. The documentation also did not include copies of owners' plans for remedying any deferred maintenance and financial problems to improve projects' viability. For a project to receive LMSA funding, the Code of Federal Regulations requires that there be a reasonable assurance that applying LMSA funds will result in the project's long-term viability. The code cites seven factors that should be considered in assessing whether long-term viability can be achieved. Some of the factors are that (1) the project's major problem is traceable to inadequate cash flow, (2) LMSA will solve the cash-flow problem by making it possible for the owner to raise rents and reduce vacancies, and (3) the owner's plan for correcting any deferred maintenance or other financial problems is realistic.

The 1983 and 1984 memoranda instructed the field offices to comply with the code, but headquarters did not specify exactly what constitutes compliance or instruct the field to submit documentation supporting compliance. Our conversations with loan servicers and their supervisors indicated that no documented process was used to assess whether the provision of LMSA funds would reasonably ensure the long-term viability of a project. Rather, the field staff generally identified projects for funding consideration based on their general knowledge of a project and its problems. This approach was taken for two reasons. First, in both 1983 and 1984, the field had only 2-1/2 weeks to respond to headquarters' request for project identification. This short lead time essentially precluded the field offices from performing a documented analysis of the cash-flow situation of projects experiencing financial problems and explaining how LMSA funds would likely resolve these problems. Second, field office officials stated that a loan servicer's personal knowledge is often the best means for identifying projects needing program assistance. The Detroit office officials, for example, said that there was no substitute for their loan servicers' personal knowledge of projects because their loan servicers receive financial reports monthly for each of their projects and are frequently in contact with project managers and/or owners.

Although the field offices may have accurately identified the projects most in need of assistance, the information supplied to HUD headquarters did not specifically explain how the use of program funds would reasonably ensure long-term project viability. Field office narratives submitted to headquarters in 1983 varied in their description of projects and did not provide a clear dollar linkage between projects' financial problems and how LMSA funds would resolve these problems. Also, requested statistical information in 1983 and 1984 did not include the cash shortage of a project.

We reviewed the field office narratives submitted to headquarters for the 7 Detroit, 5 Grand Rapids, and 12 Cleveland projects funded in 1983. (Boston and Philadelphia received no LMSA funds.) None of the narratives for the 24 projects funded included dollar figures on the actual cash shortage the project was experiencing and its relationship to the requested amount of program funds. Therefore, headquarters could not assess whether the requested funds would likely resolve a project's cash-flow problems and provide reasonable assurance of a project's long-term viability. For example, the narrative for a Detroit project stated that there "is a large cash shortage" but did not provide any dollar figure on the actual shortage or compare the shortage to the LMSA request. Similarly, narratives for Grand Rapids projects mentioned vacancies caused by economic conditions and deficit cash flow caused by the area's and the state's depressed economy but did not specify the amount needed to cure a project's financial deficit.

In addition, narratives for some of the 24 projects based their justification for program funds largely on anticipated future cash-flow problems. For example, the narrative for one Grand Rapids project stated that the project was currently not in default but ". . . we foresee . . . possible future physical and financial deficiencies without . . ." LMSA funds. Again, the narrative did not provide headquarters with enough information on a project's anticipated cash-flow problem and whether the amount of LMSA funds requested would resolve this problem.

In 1984, the relationship between projects' financial problems and the infusion of LMSA funds to resolve the problems was also unclear. Headquarters decided to fund the lesser of an insured projects' vacant units or requested units. In most cases, the number of vacant units in insured projects was less than the number of units requested by a field office. For insured projects funded in fiscal year 1984, assistance was requested for about 12,000 units, whereas only about 4,000 units were funded. Because headquarters did not require the field to identify and relate cash-flow situations to the amount of LMSA funds requested, headquarters could not ascertain whether funding only vacant units will resolve projects' financial problems.

The Code of Federal Regulations also states that long-term project viability should be based on an owner's realistic and achievable plan for remedying any deferred maintenance or other financial problems. However, neither the 1983 or 1984 memoranda required copies of owners' plans. Instead headquarters required field offices to submit a dollar figure representing an owner's prior contributions to a project over the past 2 years. In 1983, field offices were also required to submit a figure representing an owner's expected 1-year future contribution, a figure headquarters later found not always to be "hard." This figure, however, could have caused a project to receive a higher funding priority than appropriate. The field offices in 1983 and 1984 were not required to document the extent to which a project had deferred maintenance or other financial problems not curable with LMSA funds. Without this information, headquarters has no context in which to consider whether the owner's contribution is adequate to address these other problems. For example, comparing project A, where an owner's contribution may be $100,000, with project B, where an owner's contribution may be $50,000, could be misleading if the financial problems at the two projects were $500,000 and $50,000, respectively. In the former case, the owner's contribution would resolve only 20 percent of the project's problems whereas 100 percent would be resolved in the latter case.

Clarification needed on how to consider tenant income in selecting projects for funding

HUD headquarters in 1983 and 1984 did not instruct the field to consider tenant income in identifying projects with the greatest potential for default or to submit data on the income level of tenants, as related to rent (rent-to-income ratio). Consequently, headquarters was not in a position to include this factor in its prioritization and selection of the most deserving projects. The ratio of tenant rent to income is an important consideration because of its relevance to decisions involving (1) insuring the long-term viability of a project, (2) promoting the well-being of low-income tenants, and (3) reserving LMSA funds for the projects selected.

Long-term project viability

The income level of tenants has a direct bearing on the ability of an owner to raise rents to cover increases in operating expenses. Without sufficient rental income a project may find itself in a deficit cash-flow position (expenses greater than revenues) that threatens its long-term viability.

The occupancy rate criterion, used by headquarters in its 1984 prioritization and selection process, did not consider the impact of tenant income on project viability. Headquarters assigned points for the occupancy rate criterion on the assumption that a high project occupancy meant the project had less need for LMSA assistance. (See app. II.) This assumption does not recognize tenant income levels. Projects with 100-percent occupancy can be financially troubled if rent increases to cover operating costs cannot be made because a large proportion of the residents already pay a high percentage of their income for rent.

Loan servicers in the Boston and Philadelphia offices said that they believed HUD should consider a tenant's income when identifying and selecting projects needing LMSA funds. In 1984, four of the six projects the Philadelphia office was submitting for funding consideration had, according to Philadelphia loan servicers, occupancy rates greater than 95 percent but were being submitted primarily because the tenants were already paying over 30 percent of their income for rent or would be paying over 30 percent if rent increases were approved. Without rent increases, loan servicers said they believed these projects were vulnerable to mortgage defaults. However, information on tenant income at these projects was neither requested nor disclosed when the field submitted information to headquarters.

Well-being of low-income tenants

In addition to affecting project viability, tenant income also impacts a second area--promoting the well-being of low-income persons. A low-income person whose rent-to-income ratio is higher than that of another low-income person generally has a greater need for assistance.

The amount of program assistance paid to a project owner is the difference between a tenant's rent and 30 percent of his or her income. The tenant pays a maximum of 30 percent of his or her income as rent, and the program funds cover the rest. Generally, the higher the tenant's rent-to-income ratio, the more program funds paid to the owner. The two examples below illustrate how LMSA assistance per unit varies depending on tenants' income. Assume in each case that an insured project has 100 units, and the tenants in half of the units are in need of program assistance.

Case 1: The monthly unit rent is $200, and the tenant's monthly income is $400. Without any program assistance the tenant pays $200 for rent and has $200 available for other expenses. In this situation, the tenant is paying 50 percent of his or her income in rent. If program funds were available to this unit, the amount of monthly assistance would be \$80--the difference between the rent (\$200) and 30 percent of the tenant's income (30 percent x \$400 = \$120)--or \$960 per year. For all 50 needy tenants in the project, the annual assistance would be \$48,000 (\$960 a unit per year x 50 units).

Case 2: Now assume a unit's monthly rent is \$200 and the tenant's monthly income is \$600. Without program assistance, the tenant pays \$200 for rent and has \$400 available for other expenses. In this situation, the tenant pays 33 percent of his or her income for rent. If program funds were available to this unit, the monthly assistance would be \$20--the difference between the rent (\$200) and 30 percent of the tenant's income (30 percent x \$600 = \$180), which amounts to \$240 per year. For all 50 needy tenants in the project, the annual assistance would be \$12,000 (\$240 a unit per year x 50 units).

Assuming that LMSA funds are limited and are allocated to units in projects whose tenants pay a large percent of their income for rent (case 1), rather than to units in projects whose tenants pay a smaller percentage of their income for rent (case 2), fewer overall units will receive program assistance, but tenants with a greater need--a more severe financial situation--would be helped.

Reserving LMSA funds for projects

Program funds are generally reserved for 15 years but allocated annually. The amount reserved often exceeded the amount of LMSA funds paid to project owners. This situation occurred in part because tenant income was not considered in estimating and reserving funds for a project. Instead, funds were reserved for projects on the basis of a fixed percentage of unit rent. The amount of funds paid to an owner, however, is not based on a fixed percentage but is the difference between rent and 30 percent of the income of the unit's tenants. We did not review the impact of using a fixed percentage of unit rent to determine the amount of program funds needed for a project because that issue was generally outside the scope of this review. However, after reviewing accounting records for projects in three field offices and finding a large amount of funds reserved for projects but not paid to project owners, we are concerned that, due to the limited amount of program funds, some needy projects may unnecessarily go unassisted.

We identified 52 projects that received program funds in fiscal years 1976-78 and found substantial amounts of program funds had accumulated for some of these projects. HUD officials said that this could have occurred because of the large number of units--about 110,000 available during the program's first year--and the rush to allocate the units and associated funds. We selected 4 projects in the Cleveland office, 17 projects in the Detroit office, and 31 projects in the Philadelphia office. For each field office, we calculated (1) the amount of LMSA contract authority available for these projects during the first year, (2) the amount of funds paid to the projects' owners during the projects' first complete fiscal year, and (3) the amount and percent of unexpended contract authority during the first year. The results, shown below, illustrate the large amount of unused program funds after the first year.

Program Funds Available, Spent, and Unspent
During Projects' First Year

	Cleveland	Detroit	Philadelphia	Total
	(millions)			
Amount of LMSA funds available	$0.5	$2.5	$3.6	$6.6
Amount of funds paid	$0.4	$1.3	$1.7	$3.4
Amount of unexpended program funds (and percent)	$0.1 (20)	$1.2 (48)	$1.9 (53)	$3.2 (48)

Additionally, for the 31 Philadelphia projects, $8.6 million in unused program funds had accumulated by the end of the fifth year. Moreover, for 16 of these projects, the unused assistance exceeded $250,000 per project by the end of the fifth year. For all 6 of the 17 Detroit projects that continuously received LMSA funding through January 1984, the accumulated unused funds were about $1.9 million, or an average of about $316,000 a project.

The field office cases cited are not necessarily representative of the projects in all field offices. However, they do raise questions about how to address funds available for projects and not spent, especially when many projects requesting assistance remain unfunded.

HUD's Director, Office of Multifamily Housing Management, told us that he believes field offices currently do a better job of calculating requested contract authority than they did in the past. Our review of the funds drawn down through February 1984, against fiscal years 1982 and 1983 LMSA contracts for projects in the Detroit, Grand Rapids, and Cleveland offices disclosed that the estimates are not necessarily better than in the past. For example, 8 of the 10 Cleveland projects that received LMSA funds for the first time in 1983 and for which financial information was available had not drawn down about $324,000, or 79 percent of the $412,000 they could have drawn down during the 3 months, on average, the contracts had been in effect.

Similar situations existed in the Grand Rapids and Detroit offices. In Grand Rapids, of the six projects that received LMSA funds for the first time in either fiscal year 1982 or 1983, about $260,000, or 64 percent, of the amount available had not been drawn down in the period the contracts had been in effect (average of about 8 months). For 16 Detroit projects that received LMSA funds for the first time in fiscal years 1982 and 1983, about $694,000, or 44 percent, of the funds available had not been drawn down during the time the contracts had been in effect (about 11 months).

Headquarters officials and field office staff said that contract authority (annual program funds reserved for a project) that is unspent at the end of a year can be carried forward for use in future years. HUD officials said that contract authority had always been computed as a fixed percentage of unit rent because (1) projects would probably use all of their reserved contract authority to cover rent increases by the end of the 15-year budget period and (2) this approach was simpler for field offices to follow than basing computations on tenants' actual income.

Beginning in fiscal year 1984, the LMSA budget authority was reduced from 15 to 5 years. This means that each unit funded initially in 1984 has program funds available for spending for 5 years, whereas units funded prior to 1984 had program funds available for spending for 15 years. This change substantially reduces the time available to spend program funds. When the amount of program funds is small and the demand high, as was the situation in fiscal years 1983 and 1984, it is important to be as accurate as possible in calculating the amount of annual contract authority that will be needed and used, so that as many units as possible can receive assistance.

HUD recognizes that some projects received more funds than they currently need or will need in the future, while other projects do not have enough funds to meet current needs. HUD is attempting to determine if it has the budgetary and legal authority to transfer funds from projects with unused funds to projects needing additional funds. If funds are not transferable among projects, then a large amount of unused funds may accumulate at the end of the projects' 15- or 5-year spending period. HUD officials do not agree on what would happen to these funds at that time.

CONCLUSIONS

HUD can improve its process for selecting projects to receive LMSA funds. We identified the following four weaknesses in HUD's fiscal year 1983 and/or 1984 allocation process. First, financial data used to identify projects with the greatest potential for default on insured loans was missing from, or outdated in, HUD's computerized risk analysis system. Second, projects' chances for receiving assistance were less in some field offices than others because the field offices used different criteria to compute the number of units and amount of program assistance requested. Third, field office funding proposals did not include documentation on how program funds would ensure projects' long-term viability, especially how LMSA funds would solve cash-flow problems. Fourth, tenant income, which impacts on the amount of rent the project owner can charge and, consequently, on project viability, was not a factor that field offices were directed to consider in identifying projects and submitting funding proposals to headquarters. In our judgment, these weaknesses could have been minimized if HUD headquarters had issued more specific criteria and procedures to the field offices. Strengthening the allocation process should better ensure the selection of the most deserving projects and is particularly important since recent demand for program funds far exceeded funds available.

RECOMMENDATIONS

We recommend that the Secretary of HUD develop specific procedures for identifying and selecting projects to be funded and that the procedures be incorporated into the LMSA handbook and the Code of Federal Regulations. These procedures should

--explain to field offices how factors used to identify and select projects to receive LMSA funds (for example, imminent danger of default, number of units requested, and owner contribution) are to be determined, documented, and evaluated;

--instruct the field offices to document clearly for headquarters that (1) projects' financial problems are traceable to inadequate cash flow and (2) the infusion of program funds is expected to provide a reasonable assurance of long-term project viability; and

--state clearly the extent to which tenants' financial situation (measured in terms of rent-to-income ratio) should be (1) considered by field offices when identifying projects and (2) documented when submitting funding proposals to headquarters.

CHAPTER 3

USE OF LMSA FUNDS FOR HELD PROJECTS:

AN ISSUE NEEDING CLARIFICATION

HUD targeted LMSA funds for insured projects, rather than held projects, in fiscal years 1983 and 1984. Because the largest drawdown on the insurance fund occurs when an insured project becomes a held project, targeting program funds to insured projects is consistent with the program goal of reducing government outlays from HUD's insurance fund. In fiscal year 1984, however, HUD instructed its field offices to consider funding for held projects if (1) the projects' mortgages could be made current in a very short period of time, (2) the owner had invested significant capital, and (3) it would be cost-effective. However, HUD did not provide guidance on how to measure cost-effectiveness.

Program guidance in the Code of Federal Regulations emphasizes that program funds be used to reduce drawdowns on the insurance fund but does not address the financial advantages of using program funds for either insured or held projects. Neither does the LMSA handbook provide guidance on the advantages of using program funds on each type of project. A more definitive policy would provide HUD with a better basis for comparing the cost-effectiveness of using LMSA funds on insured versus held projects.

MEASURING COST-EFFECTIVENESS

The cost-effectiveness of using LMSA funds for held projects depends largely on the goals of the LMSA program. According to the Code of Federal Regulations:

> "The primary goal of the Section 8 Loan Management Set-Aside Program is to reduce claims on the Department's insurance fund by aiding those FHA-insured or Secretary-held projects with immediately or potentially serious financial difficulties. A first priority should be given to projects with presently serious financial problems, which are likely to result in a claim on the insurance fund in the near future. To the extent resources remain available, assistance also may be provided to projects with potentially serious financial problems which, on the basis of financial and/or management analysis, appear to have a high probability of producing a claim on the insurance fund within approximately the next five years."

As mentioned on page 1, the largest drawdowns on the insurance fund occurred when insured projects became held.

Therefore, because a goal of the LMSA program is to reduce claims on the insurance fund, HUD, in fiscal years 1983 and 1984, targeted LMSA funds for insured projects. In fact, the Director, Office of Multifamily Housing Management, explained that it was HUD's intention to exclude held projects from consideration in 1983, even though the May 12, 1983, memorandum did not make this clear. Consequently, the field offices submitted 19 held projects. Two of these projects were ultimately funded because headquarters, according to a HUD official, initially thought the projects were insured and evaluated them as such during the selection process. In 1984, HUD specifically instructed its field offices to consider held projects for LMSA funding if, among other things, it could be demonstrated that using LMSA funds would be cost-effective. Headquarters did not explain how the field offices were to assess cost-effectiveness, nor did it require that the assessment be documented and submitted along with any held project identified for LMSA funding. Of the 362 projects submitted for funding consideration in fiscal year 1984, 60 were held.

Our meetings with loan servicers and their supervisors disclosed that the field was not computing the cost-effectiveness of using LMSA funds on held, as opposed to insured projects. For held projects, the field offices also were not assessing cost-effectiveness that related LMSA expenditures to future drawdowns on the insurance fund or to HUD disposition costs. Rather, the field staff stated that they were going to submit to headquarters those held projects that had financial problems that they believed could be resolved with LMSA funds.

We believe HUD should clarify how to measure cost-effectiveness for held projects in order to provide reasonable assurance that program funds are spent effectively and in accordance with program objectives, as contained in HUD's regulations and guidance. Aside from trying to minimize drawdowns on the insurance fund, HUD needs to address whether cost-effectiveness should be assessed in the broader context of the overall costs avoided by the federal government if a project is disposed of with additional government subsidy. Although drawdowns on the insurance fund are smaller during the time when a project is held, in foreclosure, and owned by HUD in comparison to when a project becomes assigned to HUD, major expenditures--section 8 subsidies--are often associated with disposing of a project when HUD owns it.

Under its disposition policy, HUD often sells multifamily housing projects with 15-year section 8 subsidies attached. This policy was established to help guarantee that decent, safe, and sanitary housing would remain available to, and affordable by, lower income families. We compared the fiscal year 1983 average per unit section 8 disposition subsidy--$4,409--with the average per unit 1983 LMSA subsidy--$2,953. Accordingly, if a well-managed held project can subsequently be made financially healthy through the use of LMSA funds, then HUD may avoid the higher subsidy associated with a project's disposition as well as the additional costs associated with foreclosure and maintaining the project until it is sold.

Another dimension of cost-effectiveness is how well LMSA funding contributes to resolving projects' financial problems. Short of a complete financial analysis of a project, we believe an indication of the effect of LMSA assistance in resolving a project's financial problems is whether the project's status (insured or held) remains the same over time after being funded. HUD's data base does not identify each project that received LMSA, its current status, and its status at the time of funding. Consequently, we could not develop overall program statistics on the extent to which LMSA funds are helping resolve the financial problems of held, as well as insured, projects.

Lacking overall program data, we used manual records maintained by the Detroit field office to identify 132 projects funded under the LMSA program between fiscal years 1976 and 1983. We found that 84 projects were insured and 48 were held when they initially received LMSA funds. As of November 1983, 79 insured projects, or 94 percent, were still insured, whereas only 35 held projects, or about 73 percent, were still held. The other five insured projects became held, moved into foreclosure, or were sold, while the remaining held projects were in foreclosure, were acquired by HUD, or were sold, and the status of one project was unknown. These statistics indicate that it may be more difficult for the Detroit office to correct the financial problems of held, rather than insured, projects by applying LMSA funds.

Since various factors, such as owner/management commitment and general economic conditions, can affect a project's financial viability, we recognize that our above comparison of using LMSA funds for insured versus held projects has limitations. Further, we recognize that no overall conclusions on the impact of LMSA funds should be drawn based on data from only one field office. However, the accumulation of similar data on project status from each of HUD's field offices could provide a better insight into how effectively LMSA funds help to stabilize the financial condition of both insured and held projects. Knowing the past effect of the LMSA program on both types of projects could better help HUD in deciding how to allocate future program funds between insured and held projects.

CONCLUSIONS

HUD needs to develop a methodology to implement its current policy of allowing held projects to receive LMSA funds. HUD instructed the field offices in 1984 to consider held projects for funding, if, among other things, it could be demonstrated that using LMSA funds is cost-effective and in the government's best interest. Headquarters, however, did not issue guidance on how to measure cost-effectiveness for held projects. We believe that clarification of the cost-effectiveness issue is needed to better ensure that the most deserving projects--insured or held--are identified by field offices and selected for funding by headquarters.

RECOMMENDATION

We recommend that the Secretary of HUD insert in the LMSA handbook and the Code of Federal Regulations a methodology to measure and compare the cost-effectiveness of using LMSA on insured versus held projects. The methodology should explain whether, for a well-managed held project, cost-effectiveness should be measured only in the context of minimizing expenditures from HUD's multifamily insurance fund or in the broader context of the overall costs avoided by the government if a held project is likely to go into foreclosure and eventually sold with subsidies to lower income tenants.

United States Senate

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

August 15, 1983

Honorable Charles A. Bowsher
Comptroller General
General Accounting Office
Washington, D.C.

Dear Mr. Bowsher:

I am writing to ask the General Accounting Office to study the Department of Housing and Urban Development's current policy regarding the use of Section 8 loan management units for projects with "Secretary-held" mortgages.

HUD regulations (24 CFR 886.101(c)) state that "the primary goal of the Section 8 Loan Management Set-Aside Program is to reduce claims on the Department's insurance fund by aiding those FHA-insured or Secretary-held projects with immediately or potentially serious financial difficulties. A first priority should be given to projects with presently serious financial problems, which are likely to result in a claim on the insurance fund in the near future. To the extent resources remain available, assistance also may be provided to projects with potentially serious financial problems which, on the basis of financial and/or management analysis, appear to have a high probability of producing a claim on the insurance fund within approximately the next five years."

I hereby request that GAO evaluate whether rigid adherence to the Department's current policy may in some instances cause avoidable disruptions for tenants and costs to the taxpayers. The study should assess the degree to which (1) benefits of local ownership may be lost, (2) under investment in project repair and maintenance may be exacerbated and (3) taxpayers' costs through HUD foreclosure and property disposition maybe greater than if loan management assistance were provided while the projects were Secretary-held.

August 15, 1983
Page 2
Hon. Charles A. Bowsher

I ask that this study include a careful analysis of the costs and benefits, to both the Government and the tenants, of the current policy in comparison with the costs and benefits of providing loan management units for some Secretary-held projects. As part of this study, I ask that GAO survey relevant HUD field staff, State and local agencies, and private developers to identify projects or circumstances in which the use of loan management assistance for Secretary-held projects may be in the best interests of the Government and/or the tenants.

Please provide GAO recommendations regarding establishment of criteria under which loan management assistance to Secretary-held projects would be deemed appropriate and cost efficient.

I am enclosing a copy of a colloquy in which Senators Garn and Huddleston agreed with me on the need for this policy review. HUD is being asked to conduct a policy review.

I ask that the GAO report be submitted to me, Senator Garn and Senator Huddleston as soon as possible but no later than December 30, 1983.

Please coordinate this review with Donald Campbell (224-9204), Wallace Berger (224-7253) and Carolyn Fuller (224-7202) of our staffs.

Sincerely,

Don Riegle

Donald W. Riegle, Jr.

Enclosure

THE ALLOCATION OF LMSA IN FISCAL YEARS 1983 AND 1984

HUD's LMSA allocation process in fiscal years 1983 and 1984 consisted of (1) HUD headquarters issuing a memorandum to its field offices instructing them which factors to consider in identifying projects that would benefit from LMSA funds, (2) the field offices identifying possible projects and submitting them to headquarters, and (3) headquarters reviewing the field data and selecting projects to receive program assistance.

Because demand for LMSA funds exceeded those available in both 1983 and 1984, headquarters developed criteria to prioritize and select projects submitted by the field offices. In 1983, headquarters evaluated each project according to three criteria--vulnerability to default, cost-benefit ratio, and owner's contribution. For each criterion, headquarters established a 1-4 score, thus creating a quartile scoring system. Projects that fully satisfied a criterion were assigned a score of 4 and placed in the criterion's highest, or fourth, quartile while those that met a criterion to a lesser degree were placed in the third, second, or first quartile and assigned points of 3, 2, and 1, respectively. Headquarters then applied a weight to each criterion and applied the weight to the 1-4 score to arrive at a composite score for each project. Lastly, headquarters ranked projects according to the composite score and selected those with the highest score for LMSA funding.

A project's vulnerability to default was determined by HUD's risk analysis system. This system combines financial and management information to produce a number ranging from 1-15 intended to reflect a project's overall financial stability. HUD headquarters considered projects with risk analysis numbers ranging from 12-15 the most financially troubled, gave them a score of 4, and assigned them to the fourth or highest quartile.

Projects with risk analysis numbers ranging from 9-11 were given a score of 3 and assigned to the second highest quartile. Projects with risk analysis scores ranging from 6-8 and 1-5 were assigned to the second and first quartile, respectively, and were given scores of 2 and 1. HUD computed the cost-benefit ratio by dividing the project's outstanding mortgage by the annual LMSA subsidy, or contract authority, requested for the project. According to HUD, this quotient, expressed in dollar terms, represents the amount of money saved from HUD's insurance fund for each dollar of LMSA requested. HUD ordered the quotients for all projects submitted from the field offices from lowest to highest. Headquarters assigned projects with quotients in the first 25 percent of the ordering to the lowest quartile, and gave them a score of 1. Projects with quotients in the next 25 percent of the ordering were assigned to the next highest quartile and given a score of 2. Headquarters used the same approach to assign projects to the third and fourth quartiles, and gave them scores of 3 and 4.

Headquarters considered an owner's past as well as anticipated future contributions to a project separately in assigning projects to respective quartiles within this criterion. Headquarters computed a quotient for each project by dividing the amount of an owner's contribution by the requested amount of annual LMSA contract authority. Thus, a project with a large contribution that requires a small amount of subsidy will have a large quotient and be assigned to the fourth (highest) quartile and be given a score of 4. The same process was used to assign projects to the third, second, and first quartiles.

After grouping the projects into quartiles, headquarters assigned weights to the criteria in accordance with headquarters' perception of their relative importance. Because headquarters considered a project's vulnerability to default the most important criterion, headquarters assigned it a weight of 45 percent. Headquarters considered a project's cost-benefit ratio next in importance (weighted 35 percent) and considered the owner's contribution least important (weighted 20 percent).

In fiscal year 1984, headquarters used four criteria to rank projects for selection. Headquarters evaluated each project by how well it satisfied each of the criteria and assigned the criteria a relative weight. A project could receive a maximum of 100 points depending on the degree to which it satisfied the 4 criteria listed below.

Fiscal Year 1984 Headquarters Project Selection Criteria

Criteria	Maximum points	How points were assigned
1. Priority order as identified by field office	40	40 pts.-- 1st priority 30 pts.-- 2nd priority 20 pts.-- 3rd priority 10 pts.-- 4th priority 0 pts.-- 5th or higher
2. Cost-benefit ratio	25	25 pts.-- ratio greater than 15 20 pts.-- ratio between 11 and 15 5 pts.-- ratio between 5 and 10 0 pts.-- ratio less than 5
3. Occupancy rate (percent)	20	20 pts.-- rate less than 80 10 pts.-- rate between 80 and 90 0 pts.-- rate greater than 90
4. Amount of owner contribution per unit	15	15 pts.-- more than \$500 5 pts.-- between \$0-\$500 0 pts.-- \$0

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