

September 2002

# MULTIFAMILY HOUSING

## Physical and Financial Condition of Mark-to- Market At-Risk Properties



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**Abbreviations**

DEC	Departmental Enforcement Center
FASS	Financial Assessment Subsystem
FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
OMHAR	Office of Multifamily Housing Assistance Restructuring
PAE	Participating Administrative Entity
REAC	Real Estate Assessment Center



G A O

Accountability \* Integrity \* Reliability

United States General Accounting Office  
Washington, DC 20548

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September 6, 2002

The Honorable Paul Sarbanes  
Chairman, Committee on Banking,  
Housing and Urban Affairs  
United States Senate

The Honorable Jack Reed  
Chairman, Subcommittee on Housing  
and Transportation  
United States Senate

The Honorable Wayne Allard  
Ranking Member, Subcommittee on Housing  
and Transportation  
United States Senate

In 1997, Congress established the mark-to-market program to help preserve the availability and affordability of low-income rental housing while also reducing the cost to the federal government of rental assistance provided to low-income households. There is a shortage of affordable housing in the United States, particularly in tight housing markets. The mark-to-market program was developed for multifamily properties<sup>1</sup> that are both insured by the Federal Housing Administration (FHA)<sup>2</sup> in the Department of Housing and Urban Development (HUD) and aided through the project-based Section 8 program.<sup>3</sup> HUD's project-based Section 8 program provides rental subsidies to participating property owners to supplement rent paid by eligible low-income families for units in those properties. The impetus for the mark-to-market program was the determination that unit rents in many of these properties exceeded those

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<sup>1</sup>Multifamily properties include dwellings with five or more units, such as apartment buildings.

<sup>2</sup>FHA mortgage insurance protects lenders from financial losses stemming from borrowers' defaults on mortgage loans.

<sup>3</sup>Under the Section 8 program, the federal government pays property owners the difference between the monthly rent on a unit and 30 percent of a family's income. This assistance can be project based (i.e., attached to the unit) or tenant based (i.e., a voucher held by the tenant). The mark-to-market program applies only to the project-based Section 8 program.

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prevailing in the market, resulting in higher federal subsidies to property owners.

Under the mark-to-market program, at the time of the assisted properties' section 8 contract renewal, HUD "marks" (i.e., resets) rents to prevailing market levels and restructures a property's mortgage debt,<sup>4</sup> if necessary, to permit a positive cash flow. This process is designed to ensure that properties whose rents are reduced to market level still have sufficient income to meet the mortgage payments and operating expenses on the property. The Office of Multifamily Housing Assistance Restructuring (OMHAR) was established within HUD to administer the mark-to-market program.

Property owners receiving above market rents are eligible to enter the mark-to-market process when their current Section 8 contracts are about to expire.<sup>5</sup> Once a property owner decides to enter the mark-to-market process, OMHAR determines how much the property's rents will be reduced and whether the property needs mortgage restructuring. OMHAR assigns each property that needs a mortgage restructuring to a contractor who works with the owner to develop a restructuring plan that would permit a positive cash flow in light of the reduced rents. Since the inception of the mark-to-market program, over 2,000 properties have entered the restructuring process. Of these, over 200 properties that needed a mortgage restructuring have not completed the process. These properties represent 15,301 units and approximately \$207 million in outstanding mortgage principle. OMHAR believes these properties are at risk of physical and financial problems because, according to the contractors' financial analyses, the properties will not have sufficient cash flow to meet their mortgage payments and operating expenses without restructuring. Moreover, because these properties are insured by FHA, if any of the properties should go into default, FHA will likely be responsible for paying the lender's claim. In order to closely monitor these properties, OMHAR placed them on a watch list and, in concert with HUD's Office of

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<sup>4</sup>Restructuring mortgage debt can include lowering the total mortgage, lowering the monthly payments, or both.

<sup>5</sup>Within 120 days of the date Section 8 project-based contracts are set to expire, owners are required to notify HUD of their intentions to opt out or remain in the program. In some cases, a property may have multiple Section 8 contracts.

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Multifamily Housing, developed and implemented new monitoring procedures for them.<sup>6</sup>

Because of your concerns about the possible problems associated with the watch-list properties, you asked us to examine HUD's oversight of these properties. As agreed with your offices, this report examines (1) the reasons OMHAR places Section 8 properties on the watch list, (2) the physical condition of the properties, (3) the financial condition of the properties, and (4) HUD's monitoring procedures for the properties.

To assess the reasons that Section 8 properties were placed on the watch list, we analyzed available data from OMHAR. We also conducted telephone interviews with contractors responsible for developing the restructuring plans for a random sample of these properties. To determine the physical and financial condition of the watch-list properties, we analyzed data on the results of HUD's physical inspections and assessments of annual financial statements submitted by property owners. To examine the procedures that HUD uses to monitor the watch-list properties, we (1) reviewed HUD guidelines for monitoring properties and (2) discussed the implementation of the guidelines at selected HUD field offices. We also conducted case studies for six watch-list properties to obtain detailed information on the reasons they were placed on the watch list, the implications of their rents being reduced to market levels, the physical and financial condition of the properties, and HUD's role in monitoring them. For detailed descriptions of the properties included in our case studies, see appendixes I through VI. Data are current as of April 2002, unless otherwise noted. We conducted our review from October 2001 to July 2002, in accordance with generally accepted government auditing standards. (See app. VII for additional discussion of our scope and methodology.)

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## Results in Brief

OMHAR places federally assisted, FHA-insured properties on the watch list when their rents have been reduced to market level under the mark-to-market program, but they have not had their mortgages restructured. Two-hundred and eleven properties have been placed on the watch list, for one of three reasons: (1) the property owners elected not to enter into or complete the mortgage restructuring process, even though OMHAR has

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<sup>6</sup>Once properties are placed on the watch list by OMHAR, they become the monitoring responsibility of local HUD field offices.

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determined that such a restructuring is needed to allow the property to have sufficient cash flow to meet its mortgage payments and operating expenses (177 properties, or 84 percent); (2) OMHAR determined that the property was not financially viable for restructuring (31 properties, or 15 percent); and (3) the property owners were disqualified from the mortgage restructuring process because of certain actions by the owner, such as financial or managerial improprieties (3 properties, or less than 1 percent). According to contractors who worked with property owners to develop restructuring plans, owners most commonly opted out of the restructuring process because they did not want to accept certain HUD requirements related to the mortgage restructuring or because they believed that their property could operate sufficiently at the reduced rents.

Eighty-seven percent of OMHAR's watch-list properties received HUD inspections that indicated they were in satisfactory physical condition, but some of these inspections occurred before the properties were placed on the watch list. Specifically, 182 of the 211 properties received satisfactory physical inspection results. However, 75 of these 182 properties have not had a physical inspection since being placed on the watch list. The timing of HUD's inspection cycle depends on the results of each property's most recent inspection. As a result, a watch-list property that received a high score on its previous physical inspection may not be reinspected for up to 3 years from the last inspection. Twelve percent (26) of the watch-list properties received inspection scores indicating that they were in substandard condition, and about 1 percent received scores indicating they were in severe condition.

While OMHAR believes that all properties on the watch list are potentially at financial risk, HUD's Financial Assessment Subsystem—which contains information on property owners' audited annual financial statements—indicates that 62 percent of the watch-list properties show signs of potential financial risk. Moreover, 46 percent of the watch-list properties have financial indicators that suggest that they do not have sufficient income to cover their mortgage payments. HUD officials said these data should be used in conjunction with other information to assess a property's overall financial condition.

HUD established guidance for monitoring the watch-list properties 10 months ago, but it is too early to assess how effective the monitoring will be. Implementation of this guidance has been slow and inconsistent among the field offices we visited. HUD's watch-list guidance, which was issued in September 2001, is based on the premise that such properties should be closely monitored because they are at risk of developing



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physical and financial problems. However, HUD only recently developed the format for a quarterly report required by the guidance, and we observed that the guidance was not being consistently implemented across the HUD field offices we visited.

In commenting on a draft of this report, HUD stated that we provided it with valuable advice and guidance during our review, but provided some clarifying comments and suggested technical modifications, which we have incorporated into this report as appropriate. For example, in response to our assessment that implementation of the watch-list procedures has been slow and inconsistent at the field offices we visited, HUD commented that new procedures disseminated to Multifamily HUB Directors in July 2002, such as guidance on quarterly reporting, will ensure more consistent oversight of these properties. Moreover, HUD stated that it was taking other measures to improve oversight, such as using Real Estate Assessment Center (REAC) real estate financial specialists to analyze watch-list properties' financial statements and providing this information to field office managers to assist in their monitoring of such properties.

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## Background

To date, over 800,000 units in approximately 8,500 multifamily housing projects have been financed with mortgages insured by FHA and supported by project-based Section 8 housing assistance payments contracts. Many of these contracts set rents at amounts higher than those of the local market. As these housing subsidy contracts expire, Congress has mandated that the rents on these privately owned multifamily properties be lowered to market levels.

For those properties identified by HUD as having above-market rents, Congress created the mark-to-market program in 1997 to reduce rents to market levels and restructure existing mortgage debt to levels supportable by these rents. The goals of the mark-to-market program include preserving the affordability and the availability of low-income rental housing, while reducing the long-term costs of Section 8 project-based assistance. The restructuring generally involves resetting rents to market levels and reducing mortgage debt, if necessary, to permit a positive cash flow. To facilitate the restructurings, Congress provided OMHAR with certain tools, such as the ability to reduce an owner's mortgage payments by creating a new first mortgage and, where necessary, deferring some of the debt to a second mortgage, which is only required to be repaid if sufficient cash flow is available.

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The mark-to-market process begins when a property's existing Section 8 project contract is nearing expiration and the owner decides to remain in the program. Before a new Section 8 contract is awarded, these property owners are required to submit to HUD a market study that contains information on market rents for comparable properties located within the subject property's geographic area. Local HUD field offices review these market studies and, where studies show a property owner's rents are not above market, have the option and authority to award the owner with a new Section 8 contract. HUD field offices forward cases to OMHAR when a market study submitted by an owner shows their rents are above market. OMHAR, in turn, provides these cases to contractors, known as participating administrative entities (PAE),<sup>7</sup> who also conduct market studies, carry out the analysis necessary for restructurings, and prepare restructuring plans and documentation.

Under the mark-to-market program, properties whose rents are above market levels undergo one of two types of restructuring. Mortgage restructurings generally involve resetting rents to market levels and reducing mortgage debt to permit an acceptable, positive cash flow. For this type of restructuring, the PAE develops restructuring plans based on a reduction in rents and mortgage debt and submits the plans to OMHAR for review and approval. Before the restructuring plans can be implemented, owners are required to enter into a new 20-year Section 8 contract and to sign an affordability and use agreement promising to maintain restrictions aimed at preserving the designated units as affordable housing for at least 30 years—10 years beyond the Section 8 contract period. Property owners must agree to contribute 20 percent of the total cost of rehabilitation needs of the property. The remaining rehabilitation costs are included in the second mortgage that is created during the restructuring process. Rent restructuring also involves the PAEs developing restructuring plans that must be approved by OMHAR. However, these plans are based only on a reduction in the rents, not the mortgage debt. Rent restructurings are only permitted for properties that can demonstrate the ability to have acceptable, positive cash flow with a rent reduction but without a mortgage restructuring. There are no affordability and use restrictions on properties that receive rent restructuring, and the Section 8 contracts are usually renewed for 5 years.

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<sup>7</sup>OMHAR has contracts with various public and private organizations, referred to as participating administrative entities, to carry out the property restructurings.

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Approximately 211 properties have not completed the mortgage restructuring process, even though, as a result of having their rents reduced to market level, OMHAR determined that such a restructuring is necessary for the properties to have acceptable, positive cash flows.<sup>8</sup> OMHAR places properties that it believes should have had a mortgage restructuring on the watch list because it believes such properties are at risk of developing physical and financial problems stemming from insufficient cash flow. These property owners receive a 1-year renewal watch-list contract.

After OMHAR places these properties on its watch list, it becomes the responsibility of HUD field offices to monitor them as part of their asset management duties. Guidance issued by HUD in September 2001 requires HUD field offices to monitor watch properties for signs of physical, financial, and management deterioration. Based on the guidance, field office staff should review available data on the properties' physical and financial condition, and conduct periodic management reviews and site visits for properties showing signs of impending default. If a field office observes a decline in the properties' physical or financial condition, it can refer the property to HUD's Departmental Enforcement Center (DEC) for analysis and a potential corrective action plan. In cases where owners fail to comply, DEC can resort to enforcement actions, such as the issuance of civil money penalties, taking debarment and suspension actions, and recommending foreclosure.

HUD's REAC conducts physical inspections of all HUD multifamily properties, including watch-list properties. One of the key monitoring responsibilities of HUD project managers is to monitor the results of these physical inspections, which are captured in HUD's Guidance for Oversight of Multifamily Physical Inspections. HUD's monitoring guidelines direct project managers to pay special attention to properties receiving a substandard or severe physical inspection score of 59 or below, including follow-up with the property owners to ensure that all exigent deficiencies (health and safety issues) are corrected in 3 business days.

Each year HUD requires property owners to submit audited financial statements for all multifamily housing properties it insures and/or subsidizes. Using its Financial Assessment Subsystem (FASS), HUD

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<sup>8</sup>Of the 15,301 units represented by the 211 properties, 12,848, or almost 84 percent, receive Section 8 project-based assistance.

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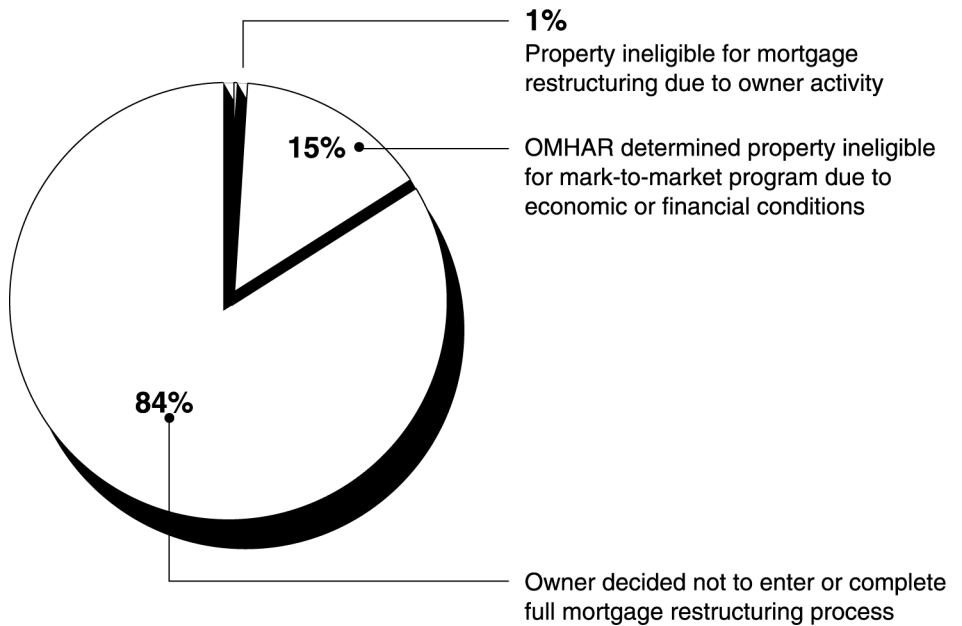
develops a score that indicates the level of financial health associated with such properties. This financial score represents a single aggregate financial measure that synthesizes data from five different financial ratios. For example, the debt service coverage ratio compares a property's net operating income to its mortgage amount and demonstrates whether the property has sufficient cash flow to meet its debt service obligations. If a property's income is equal to its debt service, the debt service coverage ratio is 1.0. Generally, HUD expects a property's income to be at least 120 percent of its debt, or have a debt service coverage ratio of 1.2 or higher.

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## Properties Are on the Watch List for One of Three Reasons

OMHAR places properties on the watch list when a property's rents are reduced to market level but its mortgage is not restructured. As of April 15, 2002, OMHAR had placed 211 properties on the watch list for one of three reasons. OMHAR assigned the majority of these properties to the watch list because the property owners elected not to enter into or complete the mortgage restructuring process, even though OMHAR had determined that the mortgage needed to be restructured. In addition, OMHAR placed some properties on the watch list because it decided that restructuring the mortgage was not financially feasible under OMHAR's guidelines. Finally, OMHAR placed a few properties on the watch list because the owner's actions, such as financial or managerial improprieties, resulted in the owner's ineligibility for a mortgage restructuring. Figure 1 below shows the percentage and number of properties placed on the watch list by reason.

**Figure 1: Reasons the 211 Properties Were Placed on the Watch List**



Source: GAO analysis of OMHAR data.

### Owners' Refusal to Restructure Mortgage Is Most Common Reason OMHAR Placed Properties on the Watch List

According to HUD data, most owners on the watch list refused to enter into or complete the restructuring process. OMHAR considers these owners "uncooperative." According to OMHAR, uncooperative owners include those who (1) fail at any point during the process to supply information needed to complete the restructuring process, (2) fail to respond in a timely manner to the PAE's proposed restructuring plan, (3) fail to address critical repair needs in a timely manner, and (4) fail to close on a viable transaction.

OMHAR officials told us that property owners did not restructure their mortgages for several different reasons. OMHAR and PAEs, who work closely with owners while developing restructuring plans, agreed that the most common reasons owners refuse to enter into or complete the restructuring process are (1) the required out-of-pocket funds for rehabilitation and repairs and (2) the owners' perception that properties could operate sufficiently at the reduced rents. Under mark-to-market program regulations, each owner who is participating in a mortgage restructuring is required to contribute 20 percent of the total cost of rehabilitation of the property. For example, the owner of one of the

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properties we visited for a case study did not complete the restructuring because he refused to pay approximately \$26,000 for contributions toward rehabilitation and escrow costs. OMHAR determined that with restructuring, the property would have an acceptable cash flow. However, because of the owner's refusal to complete the restructuring process, OMHAR believes the property does not have sufficient income to cover its debt and operating expenses. See appendix V for more information on this case study property.

Some owners chose not to have their mortgages restructured because, despite OMHAR's determination that a restructuring was necessary to provide for an acceptable cash flow, the owners felt that they could successfully operate the property at reduced cash flow. According to one housing industry representative, some owners disagree with OMHAR's conclusion that their property's mortgage needed to be restructured. The housing industry official stated that she believes that some owners have valid arguments against OMHAR's conclusion and that their properties could operate successfully at reduced cash flow. According to OMHAR, there are some properties on the watch list that may operate successfully at reduced rents until they have a major capital repair need that will affect their cash flow because they do not have sufficient reserves to cover the repair.

Another reason some property owners have not restructured their mortgages is their reluctance to enter into a 30-year affordability and use agreement, as required in the act.<sup>9</sup> This agreement requires that a certain percentage of units must be leased to families whose incomes do not exceed a certain percentage of the area median income. According to a PAE, some owners are concerned about entering into a 30-year affordability and use agreement when the contract HUD has established for a mortgage restructuring is only for a 20-year period, which leaves 10 years when the owner will have to provide affordable housing without the guarantee of a Section 8 contract. Also, an industry official representing owners noted that some owners are also concerned about agreeing to a 30-year affordability and use agreement when their property is already 20 to 30 years old and they are uncertain about the viability of their property in 30 years. According to HUD's database, most properties on the watch list are at least 20 years old.

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<sup>9</sup>Section 514(e)(6) of the act requires the owner or purchaser of the property to maintain affordability and use restrictions for a term of not less than 30 years.

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According to OMHAR, some property owners have not restructured their mortgages because they are planning to opt out of the project-based Section 8 program. When an owner chooses to opt out of the project-based Section 8 program, eligible tenants are offered assistance in the form of tenant-based vouchers, which they may use at the same property. According to OMHAR, some owners may be able to obtain higher subsidies through tenant-based assistance because the market rents established for tenant-based assistance may be higher than the market rents established for the property through the mark-to-market process.<sup>10</sup>

Secondly, OMHAR also places properties on the watch list if it determines that because of economic conditions in the market and/or a property's financial and/or physical condition, restructuring the property is not financially viable. According to OMHAR, the majority of the 31 watch-list properties that were determined to be financially nonviable were nonviable due to a combination of the economic conditions in the market and the property's financial and/or physical condition. Two of the properties we visited for case studies were declared by OMHAR to be financially not viable for restructuring. For example, one property we visited in Washington, D.C., required over \$4 million in rehabilitation and had an outstanding mortgage balance of about \$1.3 million. OMHAR determined that, given the market rents in the area, the property could not generate enough income to finance the mortgage and rehabilitation costs. The other property that we visited that OMHAR declared financially nonviable was located in Rhode Island. OMHAR determined that restructuring was not viable for this property because it had an unpaid mortgage balance of \$421,280 but appraised at only \$217,000 and required \$200,000 in rehabilitation costs. See appendixes II and III for more information on these properties.

Third, OMHAR places properties on the watch list because of an owner's actions. Under the act, owners who engage in financial or managerial improprieties may be declared ineligible for mortgage restructuring.<sup>11</sup>

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<sup>10</sup>Tenant-based assistance is calculated based on fair market rents, which sets the maximum monthly subsidy for all areas of the country.

<sup>11</sup>Financial or managerial improprieties include, among other things, violating federal, state, or local laws, breaching a Section 8 contract, and repeatedly failing to make mortgage payments.

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## Properties Can Be Removed from the Watch List for Several Reasons

Properties can be removed from the watch list for several reasons. Thus far, 70 properties that were at one time on the watch list have been removed. Under watch-list monitoring guidelines, properties can remain on the watch list for 3 or more years. According to OMHAR, a property can be removed if, after 3 years on the watch list, it has maintained its physical and financial condition. No properties have been removed from the watch list for this reason. In addition, properties can be removed from the watch list if the owners prepay their FHA-insured mortgage. Property owners who prepay their FHA-insured mortgages may continue to have Section 8 contracts but no longer represent a financial risk to the FHA insurance fund. Thirty-two properties have been removed from the watch list for this reason. Properties are also removed from the watch list if the owner decides to reenter the mortgage restructuring process, as has occurred with 32 properties. In addition, properties are removed from the watch list if the owner opts out of the Section 8 program, as has occurred with six properties.

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## Most Watch-List Properties Received Satisfactory Physical Inspection Scores

According to HUD's latest physical inspection results, the majority of watch-list properties are in satisfactory physical condition. HUD data show that 182 of the 211 watch-list properties, or 87 percent, scored 60 or higher on their most recent physical inspection—which HUD considers to be satisfactory. However, 75 of these properties have not been inspected since being placed on the watch list.

HUD uses the same criteria for determining the timing of inspections for watch-list properties as it does for other multifamily properties. Under HUD's guidelines, properties that receive a physical inspection score between 90 and 100 are to be reinspected in 3 years, properties that receive a score between 80 and 89 are to be reinspected in 2 years, and properties that receive a score of less than 80 are to be reinspected in 1 year. HUD data indicate that 131 of the watch-list properties received scores between 80 and 100 on their most recent inspection and therefore are not required to be reinspected for 2 or 3 years. According to HUD and industry officials, watch-list properties are at risk of developing physical problems because, in response to reduced cash flow, some owners are likely to cut back on routine maintenance, major improvements, and contributions to replacement reserves.

Twenty-six of the watch-list properties, or 12 percent, received a substandard physical inspection score between 31 and 59 on their most recent inspection. Properties with scores in this range may exhibit a variety of significant problems. For example, a property we reviewed in



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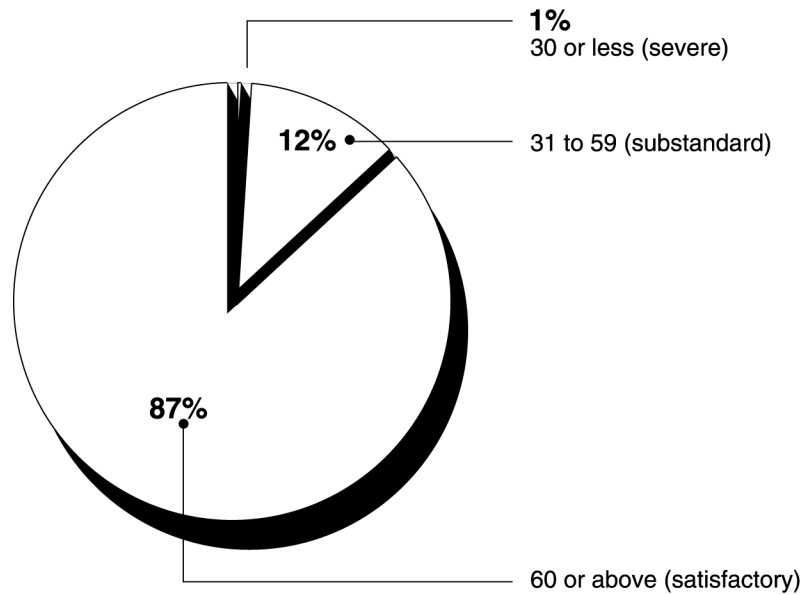
Florida for our case studies that received a score of 33 had a wide range of deficiencies, including health and safety issues, such as inoperable smoke detectors and missing or broken electrical outlets. See appendix I for more information on this case study.

Three watch-list properties, or about 1 percent of the total, received a physical inspection score of 30 or less—which HUD considers severely distressed. Severely distressed properties are likely to have major problems. One of our case study properties received a score of 21. Its roof and boilers required replacement, and there was water damage throughout the building. (See app. II for more information on this case study). Figure 2 shows the watch-list inventory sorted by the percentage of properties whose physical inspection score fell into each category.<sup>12</sup>

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<sup>12</sup>In general, the physical condition of the watch-list properties is similar to all properties that have gone through the mark-to-market process. More specifically, watch list physical inspection scores averaged just over 79, while the average physical inspection score for all OMHAR properties was approximately 83. This slight variance does not reflect a significant difference in the physical condition of the properties in the separate portfolios because both scores indicate a “satisfactory” physical condition.

**Figure 2: Percentage of Watch-List Properties Sorted By Scoring Range**



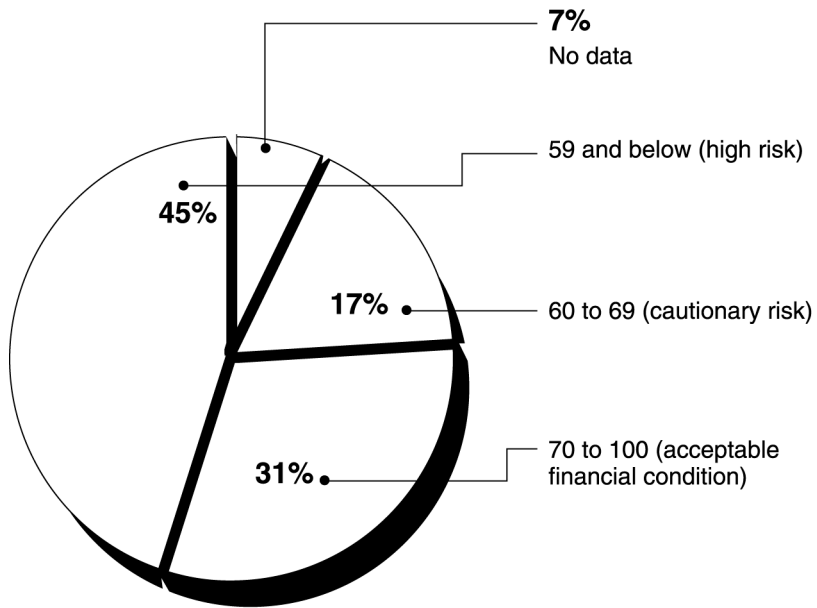
Source: HUD's Real Estate Management System database.

## Financial Assessment Scores Suggest Many Watch-List Properties Are Experiencing Financial Problems

Based on information from FASS,<sup>13</sup> which contains information from property owners' audited annual financial statements, 131 of the 211 watch-list properties, or 62 percent, show signs of potential financial risk. FASS generates a score that places properties in one of three risk categories—acceptable risk, cautionary risk, and high risk. FASS indicates that the overall financial condition for 95 watch list properties is “high risk,” while another 36 properties are “cautionary.” Figure 3 shows the percentage of watch-list properties in each of HUD's three risk categories based on their 2001 FASS scores.

<sup>13</sup>Using information from the annual financial statement, a computer model statistically calculates five financial ratios, or indicators, for each project and applies acceptable ranges of performance, weights, and thresholds for each. Examples of such ratios include a property's physical vacancy rate, mortgage debt service coverage, and reserves per unit. This information is then synthesized into an overall point value, ranging from 10 to 100, or performance risk rating, for each project. HUD uses a property's risk rating to place it into a risk category or zone.

**Figure 3: Percentage of Watch-List Properties, By Annual Financial Score**



Source: HUD's Real Estate Management System database.

In generating a FASS score, FASS uses a formula that analyzes such factors as whether a property has sufficient cash to meet its mortgage payments, operating expenses, vacancy rates, and contributions to the replacement reserve account. According to HUD officials, the overall FASS score is meant to provide HUD with information on the financial condition of its aggregate portfolio and highlight properties that warrant further investigation by spotting potential financial problems before they occur. These officials also told us that these data should be used in conjunction with other available information to assess a property's overall financial condition.

One of the indicators that are included in the FASS score is the debt service coverage ratio, which shows how much revenue is available to pay mortgage payments. We found that 97 of the 211 watch-list properties, or about 46 percent, had debt service coverage ratios below 1.0. Specifically, 73 of the 95 high-risk properties, 18 of the 36 cautionary properties, and 6 of the 66 acceptable properties had debt service coverage ratios below 1.0. This suggests that even some properties in the acceptable and cautionary

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risk categories may experience difficulty meeting their mortgage payments.<sup>14</sup>

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## HUD Has Targeted Watch-List Properties with Monitoring Procedures

HUD recently developed monitoring procedures specifically for watch-list properties, but it is too early to tell whether the guidance will be effective in monitoring the watch-list properties. HUD's implementation of these procedures has been slow and inconsistent at the field offices we visited.

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## New Watch-List Oversight Procedures Supplement Monitoring Guidelines Applicable to All Section 8 Properties

Believing that mark-to-market rent reductions in the absence of a corresponding mortgage restructuring may place the physical and financial condition of watch-list properties at risk, HUD developed oversight procedures specifically designed to protect the long-term viability of watch-list properties. The procedures, introduced in September 2001, include HUD requirements that

- all properties be assigned to experienced project managers who are responsible for documenting properties' current condition as well as performing ongoing monitoring activities.<sup>15</sup>
- all property owners on the watch list are to submit monthly accounting reports for a minimum of 1 year after rent reduction. These reports are to itemize receipts and disbursements and are intended to aid project managers' analysis of financial performance.
- HUD project managers review properties' monthly accounting reports, prepare and submit quarterly status reports on all properties to HUD and OMHAR directors, and handle and resolve compliance and performance problems if revealed by the FASS review.

In addition to the above requirements, the new watch-list guidelines provide monitoring guidance to ensure field offices closely track any

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<sup>14</sup>The average FASS score for watch-list properties is 57, which places them in the high-risk category, while the average score for OMHAR's overall inventory is 63, which places them in the cautionary-risk category.

<sup>15</sup>The September 2001 guidance indicated that watch-list properties are to be assigned to "Senior Project Managers." However, in July 2002, HUD issued new guidance clarifying that these properties are intended to be assigned to "experienced or seasoned" project managers, which includes staff that have considerable experience working with troubled properties.

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changes in a property's condition. In particular, the guidance states that the project managers should pay close attention to the physical and financial condition of the watch-list properties that are assigned to them. In terms of the physical condition, the HUD guidance states that the project manager should follow-up with the owner to ensure that deficiencies are corrected. HUD also suggests that its representatives make site visits to monitor repairs, and consider requesting interim physical inspections where there are indications of diminished property viability.

The new guidelines also specify that watch-list properties are subject to existing asset management, project servicing and physical inspection guidelines applicable to all multifamily properties.<sup>16</sup> These include the detailed REAC physical inspections and annual financial reporting requirements. Other monitoring suggestions applicable to all multifamily properties include on-site management reviews when there are indicators of potential problems, and informal drive-by observations. Properties can also be referred to DEC for further actions when there are signs of potential or existing diminished property viability. DEC works with owners to correct deficiencies and can resort to actions such as levying civil money penalties, taking debarment and suspension actions, and recommending foreclosure.

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## HUD's Implementation of the Watch-List Guidance Has Been Slow and Inconsistent Across Field Offices We Visited

HUD has only recently—in July 2002—developed the format that field offices should use in developing quarterly reports for the watch-list properties—10 months after saying it would do so “shortly” in its September 2001 guidance. As a result, until now, field offices have not been able to implement this aspect of the guidance. Furthermore, during our review, we visited selected HUD field offices and found differing levels of compliance with other aspects of the watch-list monitoring guidance, specifically the experienced project manager and monthly accounting report requirements. In the six field offices we visited to review sample watch-list cases, implementation—as characterized by HUD officials—ranged from none to exceeding the minimum guidelines. At one office, officials had not assigned our sample case to an experienced project manager and were not collecting monthly accounting reports at the time of

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<sup>16</sup>In addition to the September 2001 watch-list guidance, other guidance applicable to monitoring watch-list properties include Multifamily Asset Management and Project Servicing (Handbook 4350.1) and The Revised Guidance for Oversight of Multifamily Housing Physical Inspections, issued May 24, 2001.

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our visit in April 2002; officials at another office did not introduce the guidelines until our visit in October 2001; three offices had assigned watch-list properties to experienced project managers and were requiring monthly accounting reports; and one office was assigning monitoring responsibility to a single experienced project manager, was receiving monthly accounting reports, and had gone beyond the minimal requirements by creating a computer spreadsheet to facilitate trend analysis of the monthly financial data.

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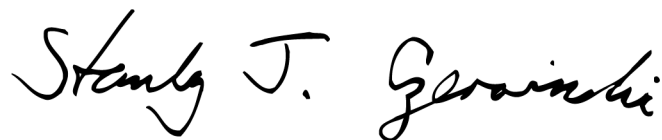
## Agency Comments

We provided a draft copy of this report to HUD for its review and comment. In its written comments, HUD's Assistant Secretary for Housing-Federal Housing Commissioner stated that we provided valuable advice and guidance during our review, but provided some clarifying comments and technical modifications, which we have incorporated into this report as appropriate. In addition, the Assistant Secretary stated that, with respect to our assessment that the implementation of the watch-list procedures was slow and inconsistent at the offices we visited, additional guidance has been sent to HUD Multifamily HUB directors that should lead to more consistent oversight. The Assistant Secretary also stated that other measures are being taken to monitor the watch-list properties, including an analysis of these properties' financial statements by REAC financial specialists and sharing the results of the analyses with project managers in the field. The full text of HUD's comments can be found in appendix VIII.

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We will send copies of this report to the Secretary of Housing and Urban Development. We will also make copies available to others on request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please call me at (202) 512-7631. Key contributors to this report are listed in appendix IX.



Stanley J. Czerwinski  
Director, Physical Infrastructure Team

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# Appendix I: Williams Apartments – Titusville, Florida

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## Background

Williams Apartments is a 37-unit Florida complex, constructed in 1969 and has been owned by the same sole proprietor since that date. The property is located in Titusville, a small town of approximately 30,000 people. There are 5 residence buildings composed of 37 units (18 2-bedroom and 19 3-bedroom). All units receive Section 8 subsidies.

The managing agent for the complex is currently the owner. He also managed the property from 1969 until 1995 and two independent management companies managed from 1995 until 2000.

The property's rents were reduced in March 2001. Based on full occupancy, the total annual rental income was reduced approximately 36 percent. The monthly rents on the two-bedroom units were reduced from \$568 to \$345, and the three-bedroom units were reduced from \$656 to \$440 (see fig. 4 below).

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**Figure 4: Photograph of Williams Apartments**



Source: HUD.

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## Reason for Placement on Watch List

The property was placed on the watch list in March 2001. The owner, who is of advanced age, refused to sign the restructuring agreement after it was completed in November 2000, and he would not provide us specific reasons for his refusal. The owner's cash contributions were set at \$25,594, including approximately \$21,000 for rehabilitation escrow. The restructured mortgage would mature in 21 years and 8 months and would provide a 1.2 debt service coverage ratio, making the property financially viable to operate.

The existing mortgage had an unpaid balance of \$205,657 as of October 2001 and will mature in October 2010.

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## Physical and Financial Condition

The Williams Apartments received a score of 33 (based on a 100-point system) on its most recent Real Estate Assessment Center (REAC) physical inspection, which was conducted in December 2001. The inspection report cited a wide range of life threatening deficiencies, including missing/inoperable electrical cover plates and blocked emergency exits. The property had received a similar low score of 36 on its prior physical inspection. HUD considers these scores to indicate that the property was in substandard condition.

In February 2001, a HUD manager stated that as a result of the owner allowing the physical condition of the property to deteriorate, the complex had been "on and off" HUD's highest risk list for the last 15 years. A contractor for HUD's Departmental Enforcement Center (DEC), where the property was referred because of physical and financial problems, stated that since 1994, the property has consistently received below average ratings on maintenance policies and procedures. The contractor visited the property in April 2001 and reported many physical problems that were cited in previous inspections. In March 2002, the HUD senior project manager received a list of complaints signed by 20 tenants. They complained of ceilings falling down, the absence of hot water, electrical outages, and plumbing problems.

Deficiencies identified by the November 2000 and December 2001 inspections have not been addressed, and the owner has not submitted the required plan of corrective actions to HUD.

The property received a financial assessment score of 65 in 1999. HUD considers this score to indicate that the property is in "cautionary" financial condition. A more current financial analysis is not available because the owner failed to submit annual financial statements for



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calendar year 2000. Also, a June 2001 HUD record indicated that the owner had repeatedly been delinquent on his mortgage payments.

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## HUD Monitoring

HUD devoted considerable monitoring attention to this property before and after its placement on the watch list and has well documented the property's physical and financial condition. The owner has shown his refusal to address the problems identified by HUD oversight, and tenants have complained that living conditions are deteriorating.

Prior to entering the watch list, the property was referred to DEC, in February 2001, because the owner failed to resolve deficiencies identified in the November 2000 inspection and repeatedly violated his regulatory agreement by collecting funds for self-management of the property. The HUD field office had required that a new management agent be appointed due to the poor management and needed physical repairs. In April 2001, the owner's attorney expressed the opinion that the owner should return the property to HUD because the mortgage and necessary rehabilitation costs far exceeded its appraised value, and the rent reduction would result in further deterioration.

In August 2001, HUD refused to grant a request that the mortgage be forgiven as part of the owner's attempt to donate the property to a nonprofit corporation. HUD specified repairs as the number-one priority and authorized the owner to begin addressing these maintenance items with funds normally reserved for capital replacements.

In October 2001, HUD notified the owner of his failure to submit complete and correct monthly accounting reports, as required by watch-list monitoring guidelines. In December 2001, DEC mailed the owner a certified letter notifying him that he was in default on his HUD housing assistance contract and regulatory agreement. Cited violations were (1) failure to properly maintain property and respond to HUD physical inspection reports, (2) failure to file and late filing of annual financial statements, and (3) late mortgage payments. He was given 30 days to take corrective action. In January 2002, the owner met with HUD and DEC officials and left with the understanding that he must respond to all REAC inspections and provide annual financial statements and monthly accounting reports.

In March 2002, HUD again notified the owner of problems with the monthly accounting reports and requested that he reimburse the project operating account \$1,673 paid to himself as manager.

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The smaller income stream, resulting from reduced rental rates, has increased the potential risk for this property. A HUD manager was of the opinion that the property would have “made it” if restructuring had been completed, but the owner had not responded to DEC’s demand for corrective action as of April 2002. Foreclosure is the next course of action. If that occurs, then the tenants will be given relocation vouchers.

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# Appendix II: Parkside Terrace Apartments – Washington, D.C.

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## Background

Parkside Terrace Apartments is a 291-unit apartment building located in the Southeast quadrant of Washington, D.C. It was built in 1966. A managing agent oversees the operations for the owner, Parkside Terrace Company Limited Partnership. The managing agent assigned an on-site manager to Parkside, which is a 12-story building consisting of 12 efficiencies, 54 1-bedroom units, 162 2-bedroom units, and 63 3-bedroom units.

The area surrounding Parkside Terrace Apartments has improved during the 1990s, but overcrowding, unemployment and poverty are still problems. Two of the three public housing developments in the area have been demolished and replaced by a new development; the third was also demolished and is now a vacant lot. The area has also experienced a drop in crime. The overcrowded rate for occupied units in the area is above 25 percent. As of February 2002, only 30 percent of Parkside Terrace Apartments' households reported having a working adult, and the median household income for all the households in the property is \$15,700.

Rents for 142 of Parkside Terrace Apartments' 291 units were reduced on April 1, 2001. The rents for these units were reduced between 13 and 26 percent. Sixty-nine units are still governed by a project-based Section 8 contract that does not expire until October 2003 and will continue to receive above market rents until that time. The remaining 80 units are not receiving Section 8 subsidies (see fig. 5).

Figure 5: Photograph of Parkside Terrace Apartments



Source: GAO.

## Reason for Placement on Watch List

On October 23, 2000, HUD's Office of Multifamily Housing Assistance Restructuring (OMHAR) determined that Parkside Terrace Apartments was not financially viable; thus, it was ineligible for mortgage restructuring. As a result, on April 1, 2001, the property was placed on the watch list. OMHAR made this determination because the property's physical condition assessment report, prepared by a contractor for the participating administrative entity (PAE), includes a 20-year repair plan

and recommends major capital replacements and repairs that would cost more than \$4.4 million in the first year. Major capital improvements have never been performed on the property. Parkside Terrace Apartments' roof, boilers, and over 500 of its windows need to be replaced. According to OMHAR, the total cost of the needed improvements to the property is too high for OMHAR to finance under the mark-to-market program.

Before OMHAR determined the property to be financially not viable, the PAE recommended that the property receive a mortgage restructuring since a rent reduction alone would leave the property with inadequate cash flow to meet its mortgage payments and finance the property's rehabilitation cost. A representative of the PAE told us that it might have been possible to restructure the property's debt despite the large rehabilitation cost, based on the assumption that tax credits and tax-exempt bond financing would be made available. However, the PAE did not perform any analysis to assess the feasibility of using tax credits and tax-exempt bonds for this purpose.

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## Physical and Financial Condition

According to HUD's physical inspection scores, the property is in poor physical condition. Its physical inspection scores have declined over time. It received a physical inspection score of 43 on February 5, 1999, and a score of 38 on December 1, 2000, both of which HUD considers to indicate poor condition. On October 30, 2001—approximately 6 months after being placed on the watch list—Parkside Terrace Apartments' received a physical inspection score of 21. Water damage was discovered in some of the property's units and hallways during the October 30, 2001, physical inspection.

Since the property received a score less than 30, it was referred to DEC. DEC's contractor inspected the property in April 2002 and discovered severe water damage, caused by leaking copper pipes throughout the building. Several balconies needed to be repaired as well.

Based on HUD's Financial Assessment Subsystem (FASS), Parkside Terrace Apartments' financial condition is cautionary. Prior to the rent reduction, the property received a financial assessment score of 69, had a debt service coverage ratio of 1.2, and a vacancy rate of about 20 percent. For the fiscal year ending December 31, 2001 (during which time the rents were reduced), Parkside Terrace Apartments received a financial assessment score of 65 and had a debt service coverage ratio of 0.7 percent (which suggests the property did not have sufficient cash flow to meet its mortgage payments) and a vacancy rate of above 22 percent. The

vacancy rate has been above 14 percent since 1996. According to the managing agent, the mark-to-market rent reduction has further contributed to Parkside's declining financial condition.

According to the managing agent, the property's expenses increased substantially in 2001. The natural gas and electricity costs increased by 300 percent and 150 percent, respectively. Parkside Terrace Apartments also experienced an increase in insurance costs as a result of the event on September 11, 2001.

HUD has approved several suspensions of replacement reserve deposits and changes in the replacement reserve deposit requirements since 1994. Property owners are required to deposit money into reserve for replacement accounts, which are intended to be used to pay for capital improvements such as roofs, boilers, and windows. In 1994, HUD required that Parkside increase its replacement reserve deposit amount from \$4,000 to \$20,000 per month. HUD approved several consecutive suspensions to its replacement reserve, as requested by the managing agent, from July 1996 to June 1999. The managing agent used these funds to renovate 30 vacant units. In September 2001, HUD's project manager assigned to Parkside approved a reduction of the deposit requirement from \$20,000 to \$3,000 per month because (1) the property experienced a significant reduction in rent under the mark-to-market program, and (2) the HUD field office determined that the existing deposit amount was too high in light of a proposal to demolish the property.

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## HUD Monitoring

HUD's District of Columbia field office (responsible for monitoring Parkside Terrace Apartments) has partially implemented the September 2001 monitoring guidance for watch-list properties. The Parkside Terrace Apartments managing agent has submitted monthly accounting reports, and an experienced project manager has been assigned to the property. However, because HUD headquarters has not provided a format to be used for watch-list properties' quarterly reports, the field office has not prepared them.

Currently, the managing agent is attempting to purchase Parkside Terrace Apartments for demolition and planning construction of a mid-rise building for the elderly and townhouses. The townhouse portion of the proposal contains a plan for both market rate and subsidized rental townhouses.

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# Appendix III: The Colony - Providence, Rhode Island

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## Background

The Colony is a 17-unit apartment complex located in Providence, Rhode Island. The building, consisting of efficiencies and one- and two-bedroom units, is a former rooming house that underwent substantial rehabilitation and became part of the Section 8 elderly housing program in 1981. In 1984, the complex received a waiver from HUD to admit non-elderly residents; the complex currently has no elderly residents. The majority of residents are single females with children. All the units are currently subsidized by HUD's Section 8 program.

The Colony is in a neighborhood of Providence (South Providence) that has a history of drug and crime problems. According to the management agent, the Colony did not house elderly residents in the early 1980s because the elderly were afraid to live in this area. While the surrounding neighborhood has improved somewhat in recent years, the immediate neighborhood continues to have significant drug and crime activity, and some nearby houses are in poor physical condition.

The watch-list contract took effect in October 2001. Under this contract, the rents were reduced by an average of 34 percent, and the total monthly maximum Section 8 payment from HUD decreased from \$12,708 to \$8,370. The owners appealed OMHAR's rent determination; subsequently the rents were increased slightly, and the total monthly maximum payment also increased to \$9,415. Ultimately, the new rents were set at 25 percent below the pre-mark-to-market levels.

The rents for the Colony were reduced in October 2001. The rents on the efficiencies were reduced from \$635 to \$475; the rents on the 1-bedroom units were reduced from \$771 to \$560; and the rents on the 2-bedroom units were reduced from \$910 to \$695 (see fig.6).

Figure 6: Photograph of The Colony Apartments



Source: GAO.

## Reason for Placement on Watch List

OMHAR placed the Colony on the watch list on November 2, 2001, because it determined that the property was not financially viable; thus, it was ineligible for mortgage restructuring. OMHAR made this determination primarily because the property was appraised at \$267,000 but had a mortgage balance of \$415,675. In addition, according to HUD and the management agent, the Colony also required approximately \$200,000 in physical rehabilitation costs.



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## Physical and Financial Condition

The Colony received a score of 80 on its most recent physical inspection, which was conducted in September 2001 (2 months prior to placement on the watch list). This represents a marked improvement from its previous scores of 24 and 66 in 1999 and 2000, respectively. The 80 score indicated that the Colony was in satisfactory physical condition. However, according to HUD and the management agent, this property had significant problems that needed substantial rehabilitation costs. Because of the previous score of 80, the Colony is not scheduled for another physical inspection for 2 years, in September 2003.

The Colony's financial condition continues to decline. The property received financial scores of 69 in 1998, 60 in 1999, and 39 in 2000. Also, since the Colony had a debt service coverage ratio of 0.7 in 2000, there is evidence that the Colony has had difficulty meeting its financial obligations even before its rents were reduced. After the rent reduction, the Colony was experiencing greater difficulty meeting its mortgage payments and have frequently been 30 to 60 days delinquent.

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## HUD Monitoring

The HUD field office has monitored this property in accordance with current HUD guidance. Specifically, the field office has assigned the Colony to an experienced project manager, who receives and reviews monthly accounting reports. In addition, the project manager conducts regular management reviews of the property, which include site visits and reviews of the property's physical, financial, and managerial condition.

The current owners of the Colony have entered into discussions with a nonprofit group to purchase the Colony. This nonprofit group has experience in successfully rehabilitating Section 8 properties in the Providence area and is interested in rehabilitating the property and using it to house elderly tenants.

According to the project manager, it would be best for the Colony to be sold to owners who are willing to contribute significant financial resources to refurbishing the property. If the property cannot be sold in the near future to an owner who is willing to pay for the substantial repairs that are needed, the project manager said he is planning to request that the tenants receive vouchers and the property be discontinued as a Section 8 property. Moreover, he said that it would not be difficult for the 17 households to find other Section 8 units in the area.

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# Appendix IV: Parkside Apartments – Gillette, Wyoming

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## Background

Parkside Apartments is a 94-unit complex located in Gillette, Wyoming. The complex consists of 4 buildings with 24 1-bedroom units and 70 2-bedroom units. All of the units are currently subsidized by HUD's Section 8 program. The property was initially occupied as a Section 8 property in February 1980, with its initial Section 8 contract expiring on February 28, 2001. The population of Gillette is approximately 19,000. There is very little alternative housing in Gillette, and the closest town is 75 miles away.

The owners of this apartment complex also have other Section 8 properties—Acadian Manor in Lafayette, Louisiana and Mountain View Apartments in San Jose, California. In addition, the owners previously owned the Pittsburgh Plaza Apartments in Pittsburgh, California. The owners of Parkside Apartments have been charged and convicted on several counts, including fraud and conspiracy at each of the HUD subsidized properties they own.

OMHAR reduced the monthly rents for Parkside Apartments in March 1, 2001, by approximately 28 percent. The rents were reduced from \$568 to \$405 for the 1-bedroom units; \$666 to \$485 for the 2-bedroom (1 bathroom) units; and \$705 to \$495 for the 2-bedroom (2 bathrooms) units (see fig. 7).

Figure 7: Photograph of Parkside Apartments



Source HUD.

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## Reason for Placement on Watch List

OMHAR placed Parkside Apartments on the watch list in April 2001 because the owners were indicted on criminal charges and suspended from conducting further transactions with HUD.

The owners of Parkside Apartments have a criminal history dating back to 1992. They were charged in 1996 by a California municipal court for crimes committed in 1992, including filing a false insurance claim, grand theft,

and falsely reporting a crime. While one of the owners was still on bail in March 1999, the owners were indicted by the State of California for welfare fraud, health care fraud, conspiracy, and six counts of grand theft. Some of the charges resulted from the owners receiving subsidy payments for apartments that were vacant in the owners' California Section 8 property, and the owners were subsequently suspended from further government contracting in October 1999. After receiving a tenant complaint that the owners were also billing HUD for vacant units at Parkside Apartments, HUD investigators raided the owner's home and Parkside's office in July 2000. The investigation revealed that the owners were receiving subsidy payments for empty apartments, just as they had in their California property. As part of the owners' plea agreement, the owners paid over \$1.4 million in restitution.

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## Physical and Financial Condition

REAC inspected Parkside Apartments in October 1999 and gave it a score of 90. HUD considers this score to indicate that the property is in satisfactory condition. Based on HUD's guidance, the property should have had a physical inspection in June 2002. As of late July 2002, the inspection had not been done.

The property's financial scores have increased annually since 1999, with all of the scores in HUD's highest performance category. The financial scores received were 73, 78, and 93 in 1999, 2000, and 2001, respectively.

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## HUD Monitoring

The HUD field office has monitored this property in accordance with current HUD guidance. The last management review was conducted in June 1999, and the property received an overall rating of unsatisfactory because the owners had not submitted annual financial statements for fiscal years 1997 and 1998. The management review also disclosed that the owners have serious unresolved internal control deficiencies in its accounting systems. In November 1998, the HUD project manager noted in the property's file that the owner was diverting funds from Parkside Apartments to his other properties. As a result, the project manager suggested pursuing sanctions against the owner if he was not indicted by the end of January 1999. The owner was indicted in March 1999.

In October 2001, the owner of Parkside Apartments entered into a settlement agreement with HUD. In this agreement, the owner agreed to be permanently disbarred from participating in any activities with the federal government. The owner also agreed to divest himself from any interest in HUD properties within 24 months from the date of the agreement. HUD's project manager stated that the owner will most likely

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opt out of the Section 8 program at the end of the 24 months and compete in the private rental market. Due to the tight housing market in Gillette, the property has a possibility of succeeding in the private rental market. According to HUD officials, however, the tight housing market will make it very difficult to relocate the existing tenants if the owners sell the property or opt out of the program.

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# Appendix V: New Haven Apartments – Athens, Texas

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## Background

New Haven Apartments is a 50-unit complex located in Athens, Texas. It was constructed in 1974. A managing agent oversees operations for the owner and an on-site manager maintains the units and collects rent. The complex consists of 8 1-bedroom, 26 2-bedroom, and 16 3-bedroom units. All of the properties' units have Section 8 project-based assistance.

There is no tenant organization, and the managing agent said he has not been aware of any tenant concerns during the mark-to-market process. However, the HUD file contains a letter to the PAE signed by 14 tenants that identifies a variety of problems, including sewage back-ups, defective air conditioners, and leaking ceilings. The occupancy rate is approximately 90 percent.

Rents were reduced for New Haven Apartments on August 1, 2001. Annual rental income, based on full occupancy, was reduced approximately 7 percent. Rents on the one-bedroom units were reduced from \$427 to \$350; rents on the two-bedroom units were reduced from \$443 to \$420; and rents on the three-bedroom units were reduced from \$496 to \$475 (see fig. 8).

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Figure 8: Photograph of New Haven Apartments



Source: GAO.

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## Reason for Placement on Watch List

OMHAR placed New Haven Apartments on the watch list because the owner rejected the mortgage restructuring plan. The management agent stated that the owner did not accept the plan because of the 25-year term mortgage agreement. Due to the age of the property (also 25 years) and the declining conditions of the neighborhood, the owner did not want to sign another 25-year term mortgage agreement. The unpaid balance on the current mortgage is approximately \$475,000, with maturity scheduled for the year 2015. However, if the mortgage was restructured, the new \$408,026 mortgage would not mature until the year 2026. In the absence of a mortgage restructuring, OMHAR predicts the property will experience a negative cash flow of approximately \$4,200 annually and a debt service coverage ratio of 0.9.

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## Physical and Financial Condition

The managing agent stated that he was uncertain whether the August 1, 2001, rent reduction has had a negative impact; but as of April 2002, New Haven Apartments has been able to maintain a positive cash flow. The on-site manager said the maintenance budget has not changed and no major maintenance problems have occurred since rent reduction. REAC's physical inspection score dropped from 81 in October 1999 to 68 in November 2001, but HUD's project manager said he was doubtful that the rent reduction contributed to the decline in the property's physical condition. He bases his statements on the fact that the November 2001 inspection occurred only 3 months after the rent was reduced. HUD considers a score of 68 to indicate that the property is in satisfactory condition and should be inspected on an annual basis.

New Haven's financial scores for the past 4 years have not varied significantly and were consistently in HUD's acceptable category. The financial score for the period ending in December 31, 2001, was 78—which represents only a 3-point drop from the previous 81 score given in December 2000. In 1998 and in 1999, the scores were 87 and 78, respectively.

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## HUD Monitoring

Representatives from HUD's Fort Worth field office (responsible for monitoring New Haven Apartments) stated that they did not implement the watch-list monitoring guidelines until we made our visit to the field office in October 2001. As required by the guidance, the managing agent has submitted the monthly accounting reports. The managing agent began submitting monthly accounting reports in October 2001, and reports through January 2002 have been submitted. The project manager stated that there has been "little or no change" in the indicators (e.g., income and vacancy rates) that HUD looks at to determine financial "health" of the property.



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# Appendix VI: Miyako Gardens Apartments – Los Angeles, California

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## Background

Miyako Gardens Apartments is a 100-unit complex located in Los Angeles, California. Developed in 1981 by a limited partnership, Miyako Gardens provides affordable housing to low-and moderate-income tenants. A managing agent oversees operations at Miyako Gardens for the limited partnership. The complex consists of 90 1-bedroom and 10 2-bedroom units, all of which are subsidized by HUD’s Section 8 program. Although not established as a property for the elderly, all of the tenants are senior citizens. According to the property manager, the complex is currently operating at 100-percent occupancy and has few vacancies each year. The complex has a waiting list of approximately 3 years.

Miyako Gardens is located in the “Japan Town” area east of the Central Business District in downtown Los Angeles. The immediate area has good appeal, consisting of a privately owned condominium, two subsidized apartment complexes, a Buddhist temple, and several restaurants. According to OMHAR’s rent comparison study and the property manager, there are no significant negative influences, and the immediate area is relatively safe, quiet, and drug free. Income and employment levels are average to above average in the area. In addition, property values and rents have increased over the past 2 years.

Prior to the mark-to-market program, rents at Miyako Gardens were set at \$907 for a 1-bedroom unit, and \$967 for a 2-bedroom unit. As a result of restructuring, rents for Miyako Gardens were reduced to \$745 and \$930, respectively. This represents a decrease of 18 percent of revenues for the 1-bedroom units, and 4 percent for the 2-bedroom units (see fig. 9).

Figure 9: Photograph of Miyako Gardens Apartments



Source: GAO.

## Reason for Placement on Watch List

Miyako Gardens was placed on the watch list in August 2001, but OMHAR later determined that the property should not be on the watch list because the owner decided to opt out of the Section 8 program. Since originally deciding to opt out of the Section 8 program, the owners have now indicated that they wish to remain in the program and OMHAR will determine whether the property requires a mortgage restructuring.

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## Physical and Financial Condition

The property received a score of 99 on its most recent physical inspection, which took place in August 1999 (2 years before the property was placed on the watch list). HUD considers this score to indicate that the property was in satisfactory physical condition. The next inspection is scheduled in August 2002. Based on our site visit, testimony from the property manager, and the rent comparison study, the property has been well managed and maintained and is in good market condition. The rent comparison study noted only very minor deferred maintenance, consisting of cosmetic touch-up items, and the property's curb appeal was rated as better than the typical property of its generation. Miyako Gardens received a financial score of 91 for 2001. This represents an increase from its two previous scores of 82 for 1999, and 84 for 2000.

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## HUD Monitoring

HUD's project manager assigned to the Miyako Gardens Apartments has not visited the complex since it was placed on the watch list. The project manager stated that, based on the high physical and financial scores and the absence of any "red flags," there has not been an urgency to inspect the property. HUD's new guidance on monitoring watch-list properties requires, among other things, that watch-list properties be assigned to an experienced project manager who monitors the property by requesting and analyzing monthly accounting reports provided by the managing agent. To date, the HUD field office has not met these requirements. The office supervisor stated that the office is short-staffed and is currently undergoing a reorganization. An experienced project manager will be assigned in the future, and the office will begin to request the monthly accounting reports.

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# Appendix VII: Scope and Methodology

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Our objectives were to answer the following questions: (1) What are the reasons properties have been placed on HUD's watch list? (2) What is the physical condition of properties on the watch list? (3) What is the financial condition of properties on the watch list? (4) What are HUD's procedures for monitoring watch-list properties?

To assess the reasons that OMHAR places Section 8 properties on the watch list, we obtained a database extract from OMHAR's Management Information System (MIS) as of April 15, 2002. This extract contained information on over 2,000 properties that had entered OMHAR's portfolio since late 1998, including properties OMHAR assigned to its watch list. We focused on the reasons why OMHAR assigns properties to the watch list and summarized the various results for each cause. We also conducted telephone interviews with the agents<sup>1</sup> responsible for developing the restructuring plans for a random sample of the properties on the watch list to determine why the owners of the properties did not complete the restructuring process.

To determine the physical and financial condition of the watch list properties, we used OMHAR's April 15, 2002, database extract and obtained a second database extract from HUD's Real Estate Management System (REMS) as of June 2002. This system contained the latest complete information on watch-list properties' physical and financial scores. We also used demographic data found in REMS to select our six case studies. To assess the physical and financial conditions of watch-list properties, we sorted this inventory into various scoring ranges and computed aggregate average physical and financial scores for OMHAR's watch-list inventory. We compared these results with similar data for all properties that have gone through the mark-to-market program, of which there are over 2,000 properties, to determine if the physical and financial conditions of each inventory is similar. To assess the reliability of OMHAR's data, we (1) performed electronic testing (specifically for accuracy, reasonableness, and completeness); (2) reviewed related documentation from HUD; and (3) worked closely with OMHAR officials to identify any data problems. Where we found discrepancies (such as nonpopulated fields or data-entry errors) we brought them to OMHAR's attention and worked with these individuals to correct the discrepancies before conducting our analyses. We determined the data we used were reliable for purposes of this report.

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<sup>1</sup>OMHAR has contracts with various firms (referred to as participating administrative entities - PAE) to carry out the property restructurings.

To assess the effectiveness of HUD's monitoring procedures, we reviewed HUD's policies and procedures for monitoring properties and discussed HUD's implementation of the policies and procedures at selected HUD field offices. We also visited a judgmental sample of properties that are monitored by HUD offices that are geographically distributed to determine whether HUD's monitoring procedures are sufficient to quickly detect signs of physical and/or financial deterioration of the properties.

In conducting our review, we interviewed officials in HUD and OMHAR headquarters in Washington, D.C., and HUD personnel in six HUD field offices—Providence, Rhode Island; Denver, Colorado; Jacksonville, Florida; Los Angeles, California; Washington, D.C.; and Fort Worth, Texas. In addition, we conducted a structured telephone interview with PAEs for a random sample of 60 watch-list properties. We also interviewed officials in OMHAR headquarters in Washington, D.C. and OMHAR staff in Chicago, Illinois. We performed our work from October 2001 through July 2002 in accordance with generally accepted government auditing standards.

# Appendix VIII: Comments from the Department of Housing and Urban Development



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY  
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

AUG 15 2002

Mr. Stanley J. Czerwinski  
Director, Physical Infrastructure Team  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Czerwinski:

Thank you for the opportunity to provide comments on the General Accounting Office (GAO) draft report: MULTIFAMILY HOUSING: Physical and Financial Condition of Mark-to-Market At-Risk Properties (GAO-02-953). The Department shares the concern of GAO and Members of Congress about the preservation of low-income housing and especially about the condition of properties with project-based Section 8 assistance that have been through the mark-to-market process and are in need of a full mortgage restructuring, but have elected just to have their rents reduced to market. The Department's "watch list" approach is intended to monitor approximately 200 properties in this situation and to ensure that the properties remain physically acceptable for tenants and financially viable for the long term. GAO has provided valuable advice and guidance during this review and its related review of the Office of Multifamily Housing Assistance Restructuring (OMHAR) completed in July 2001.

The draft report contains no findings or recommendations, noting that it may be too early to assess the guidance the Department has developed for monitoring the watch list properties and that to date the implementation of the procedures has been slow and inconsistent in the offices GAO visited. On July 25, 2002, just as the Department received the draft report, additional direction on monitoring watch list property was sent to the Multifamily Hub Directors in the field. The Department believes that Headquarters oversight through this tracking process will ensure more consistent oversight of these properties.

In addition to oversight by the field offices, the Financial Assessment Subsystem (FASS) Lab of the Real Estate Assessment Center (REAC) is reviewing the watch list properties. The FASS Lab has real estate financial specialists who are analyzing these properties' financial statements to determine the risk to the insurance fund. The results of the analyses will be shared with the field project managers to assist them in their ongoing monitoring.

The Department has reviewed the draft report and offers the following technical corrections:

- On Page 3, where the report indicates that OMHAR developed the new monitoring procedures for watch list properties, please include the point that the procedures were developed in concert with and implemented by the Office of Multifamily Housing.
- On page 4, under “Results in Brief,” the Department recommends including the point that, in addition to ensuring that these properties are closely monitored, the watch list was established to provide a mechanism for them to re-enter the mark-to-market program. As indicated later in the report, 32 properties have re-entered the mortgage restructuring process.
- On page 7, where the report discusses the monitoring of the watch list properties by the HUD field offices, it is implied that conducting periodic management reviews and site visits for each watch list property is required. Given limited travel resources and staff, such visits are required only if there is an indicator of impending default. They are also encouraged to monitor repairs necessitated by a REAC physical inspection.
- On page 8, and elsewhere, it should be noted that the Departmental Enforcement Center has other tools than civil money penalties to assist enforcement actions, including recommending foreclosure and abatement of any subsidies, taking debarment and suspension actions, and referring the matter to the Department of Justice for affirmative civil enforcement seeking double damages.
- On Page 18, and elsewhere in reference to the term “senior project manager,” the watch list guidance uses this term to mean a seasoned and experienced project manager who would be assigned to monitor the watch list properties. While there are staff persons with the position title “Senior Project Manager” (typically at the GS-13 level), the guidance intends that watch list properties be assigned to staff that has considerable experience in working with and monitoring troubled or potentially troubled properties.

The Department is committed to ensuring that the cost of the Section 8 program to the taxpayer is reduced by the mark-to-market program and that properties brought into the program continue to provide decent and affordable units to families in need of assisted housing. GAO’s assistance in monitoring this program and the Department’s performance has been very beneficial to the achievement of these objectives.

Sincerely,



John C. Weicher  
Assistant Secretary for Housing-  
Federal Housing Commissioner

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# Appendix IX: GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Stanley J. Czerwinski, (202) 512-7631  
Charles E. Wilson, Jr., (202) 512-6891

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## Acknowledgments

In addition to those named above, Andy Clinton, Mark Egger, Rafe Ellison, Reid Jones, John McGrail, Sara-Ann Moessbauer, Tinh Nguyen, John Shumann, Rick Smith, Mark Stover, and Alwynne Wilbur made key contributions to this report.



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