United States General Accounting Office

GAO

Report to Congressional Requesters

May 2000

SINGLE-FAMILY HOUSING

Stronger Measures Needed to Encourage Better Performance by Management and Marketing Contractors

GAO

Accountability * Integrity * Reliability

GAO/RCED-00-117

Contents

Abbreviations

FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development

GAO

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-284059

May 12, 2000

The Honorable Rick A. Lazio
Chairman
Subcommittee on Housing and
 Community Opportunity
Committee on Banking and Financial Services
House of Representatives

The Honorable Wayne Allard
Chairman
Subcommittee on Housing and
 Transportation
Committee on Banking, Housing and
 Urban Affairs
United States Senate

Every year, thousands of borrowers default on their single-family mortgage loans insured by the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA).[1] When borrowers default, lenders may foreclose on the properties for which the loans were secured, file claims against the FHA insurance program, and convey the properties to HUD. In fiscal year 1999, HUD acquired over 70,000 properties through these foreclosures. If HUD's acquired properties are not properly secured, maintained, and resold, they can become eyesores and may contribute to a neighborhood's decay—particularly as they age.

At the end of calendar year 1999, approximately 19,000 of 49,000 properties were in HUD's inventory for 6 months or longer—HUD's Inspector General estimated that these properties may be worth as much as $1.6 billion. These properties may lose market value as they age. In response to widespread problems with the maintenance of single-family properties reported by HUD's Inspector General and us,[2] HUD began contracting out the management and marketing of its single-family property inventory in March

[1]HUD defines a single-family property as a residential dwelling of one to four units.

[2]See *Single-Family Housing: Improvements Needed in HUD's Oversight of Property Mangement Contractors* (GAO/RCED-98-65, Mar. 27, 1998) and *Single-Family Property Disposition Program* (99-AT-123-0001, Sept. 17, 1999).

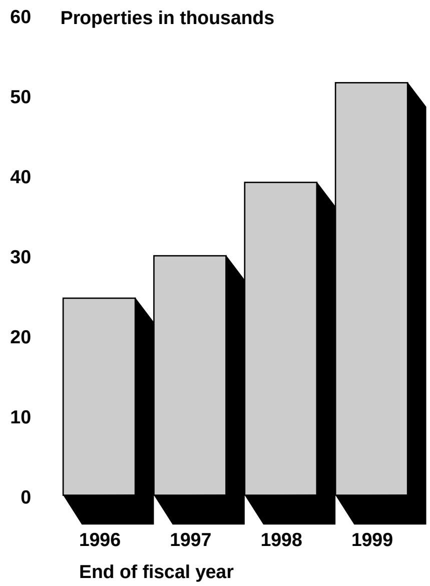
1999 and awarded a total of 16 such contracts. The contractors are responsible for inspecting, appraising, securing, maintaining, and selling the properties. For these services HUD pays the contractors a fee that is based on a percentage of the property's price. HUD pays the contractors 30 percent of their fee when they list the properties for sale and the remainder of the fee when they are sold. Concerned about HUD's disposition of these properties, you asked us to (1) describe HUD's experience with the contractors who manage and market these properties and (2) provide information on HUD's progress in reducing its single-family property inventory.

Results in Brief

The central focus of HUD's management and marketing contracts is on getting properties sold. In response, contractors have been increasingly aggressive at selling properties by using the Internet and other mechanisms to publicize the properties. However, HUD has experienced problems with these contractors on a number of fronts. Since the contracts became effective in April 1999, six of the seven contractors have had significant problems with carrying out their responsibilities particularly in regard to securing and properly maintaining the properties assigned to them. For example, InTown Management Group, which had 7 of the 16 contracts involving about 40 percent of the properties, had problems with meeting almost all of HUD's performance requirements. After trying unsuccessfully to secure better performance from InTown, HUD terminated all seven of the firm's contracts. HUD selected three replacement contractors from among the remaining firms to absorb most of InTown's workload. However, two of the three contractors that HUD selected were already having performance problems under their existing contracts. HUD staff have limited contractor incentives or tools available— short of terminating contracts—to enforce contractors' compliance and improve performance.

HUD's inventory of acquired single-family properties at the end of fiscal year 1999 was 32 percent higher than it was a year earlier and over 100 percent higher than it was at the end of fiscal year 1996. (See fig. 1.)

Figure 1: HUD's Inventory of Single-Family Properties at the End of Fiscal Years 1996-99



Source: GAO's analysis of data from HUD.

HUD's new management and marketing contractors increased the total number of properties sold from the inventory during fiscal year 1999, and the total number of properties in the inventory has now begun to decline. However, the contractors have made relatively little progress disposing of older properties—properties in the inventory 6 months or longer. In fact, as of February 2000, about 20,000 of HUD's properties were in the inventory 6 months or longer—up from 13,000 properties in April of 1999, the first month of the contracts. While HUD encourages contractors to sell properties quickly, it does not provide incentives for the contractors to focus on properties that have been in the inventory for a long period of time.

This report makes recommendations designed to improve the effectiveness of HUD's contracts for managing and marketing acquired single-family properties. While HUD agreed with some of our findings and disagreed with others, it did not comment on our draft report's recommendation. HUD does not believe that the draft report adequately recognizes many of the improvements that the program has achieved since HUD terminated InTown's contracts. We believe that our report presents a proper balance between what the program has accomplished and the shortcomings that it is still experiencing. For example, our report recognizes the improved sales performance by the contractors and the resulting decrease in HUD's property inventory. At the same time, our report notes that the percentage of properties in HUD's inventory for 6 months or longer has increased and that problems with the contractors' maintenance of the properties have persisted. Accordingly, we have not revised our report.

Background

Established by the National Housing Act, HUD's Federal Housing Administration provides hundreds of thousands of homebuyers with federally backed mortgage insurance. The mortgage insurance helps finance home purchases, many of them for low-income and first-time homebuyers, by insuring private lenders against losses on mortgages for single-family homes. From fiscal year 1997 through fiscal 1999, the number of single-family mortgage loans insured by FHA grew each year from approximately 800,000 to nearly 1.3 million—a 62-percent increase. For the 3 years combined, FHA insured over 3 million mortgages with a total value of $291 billion.

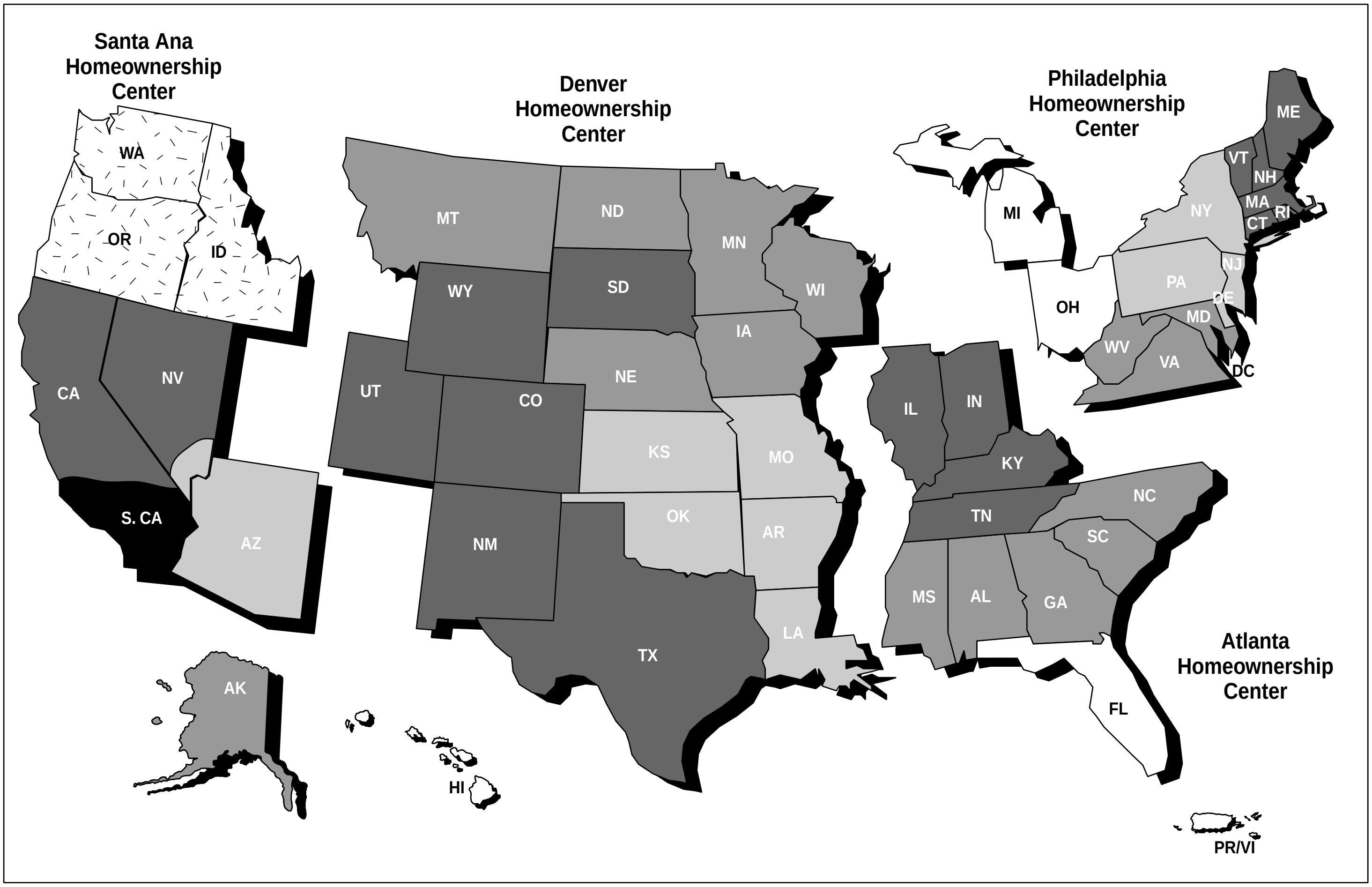
Most of these mortgages are insured by FHA's Mutual Mortgage Insurance Fund, which receives revenues through insurance premiums paid by borrowers. If a borrower defaults on a loan and the loan is subsequently foreclosed, the lender may file a claim for most of its losses with FHA. The lender transfers the title to the home to HUD after the claim is paid. HUD manages and sells the property through its property disposition program. The mission of HUD's property disposition program is to sell these properties in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the fund.

As part of an effort to streamline operations and reduce costs, HUD began a pilot program in 1996 to test the feasibility of contracting out the management and sales functions of its property disposition program. HUD determined that the pilot was successful and proceeded with a solicitation for management and marketing contracts nationwide. A panel evaluated the proposals on the basis of five selection factors: prior experience, past performance, management capability and quality control, subcontract management, and small business subcontracting. The evaluation determined which proposals offered the best value to the Department by considering the combined relative merit of these factors.

On March 29, 1999, HUD awarded seven companies a total of 16 contracts to handle most aspects of its property disposition program across the country. Each of the contracts covers a different geographic area under the jurisdiction of one of HUD's four homeownership centers.[3] (See fig. 2.) Of the 16 contracts, 3 are under the Atlanta Homeownership Center's jurisdiction, 3 are under the Denver Homeownership Center's jurisdiction, 4 are under the Philadelphia Homeownership Center's jurisdiction, and 6 are under the Santa Ana Homeownership Center's jurisdiction. When the contracts became effective, they covered 28,741 properties. This was approximately two-thirds of HUD's total inventory at the time—approximately one-third of the properties were already in the process of being sold and were not transferred to the contractors. HUD estimated that it will spend $927 million over a 5-year period for these contracts.

[3]HUD's four homeownership centers administer the single-family housing functions formerly performed by 81 HUD field offices. The homeownership centers are located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California.

Figure 2: Contract Areas



HUD's statement of work requires contractors to perform all of the management and marketing duties and responsibilities formerly performed by HUD. The contractor must inspect the property within 24 hours of assignment to determine its condition. As part of this inspection, the contractor determines whether it needs to clean out any debris to eliminate hazards and to put the property into a presentable condition. The contractor is also responsible for securing the property to prevent unauthorized entry and to routinely inspect the property to protect it and keep it in a presentable condition. As part of the sales process, the contractor is required to obtain an appraisal of the property no later than 10 business days after HUD obtains title to the property, use the appraisal to determine the list price for the property, and list it for sale. The contractor accepts sales offers and oversees the sales closings. The contractor's responsibilities also include such administrative tasks as establishing a file for each property, entering property-related data into the HUD database that tracks the status of the Department's single-family property inventory (referred to as the Single-Family Acquired Asset Management System), and reviewing the claims filed by lenders for reimbursement from HUD. The Department pays the contractors for these services in two installments—one comprising 30 percent of the total fee when the properties are listed for sale and one comprising the remaining 70 percent when they are sold.[4] According to HUD officials, the contracts are performance based because contractors are paid their full fee only if they sell the properties.

The Director of the Real Estate Owned Division in each of the four homeownership centers is responsible for monitoring contractors' performance in the respective homeownership center's jurisdiction. Staff in these homeownership centers are responsible for managing and conducting the monitoring process and preparing monthly assessments on contractors' performance. The homeownership centers have a number of resources upon which they can draw to aid them in making these assessments. For instance, HUD hired third-party contractors to inspect 10 percent of the properties handled by each of the management and marketing contractors. Another national contractor is responsible for reviewing 10 percent of the management and marketing contractors' property case files each month by following a HUD checklist. In addition, the homeownership center's program support staff conduct follow-up property inspections and file reviews on a 10-percent subset of the properties reviewed by HUD's third-party contractors, as well as a monthly on-site review at the contractors' offices. The homeownership center staff also use data from HUD's Single-Family Acquired Asset Management System and input from external sources, such as consumer groups and municipalities, in making their assessments.[5]

[4]The contractor's fee is calculated by using a "price factor," or a percentage of a property's price, specified in the contract, as agreed upon by the contractor and HUD. The first payment installment is calculated by multiplying the price factor—a specified percentage—by a property's listing price; the contractor receives 30 percent of the resulting product. The second payment installment is calculated by multiplying the price factor by the property's net sales price and then subtracting the amount of the first installment.

[5]We also discussed HUD's process for monitoring the management and marketing contractors in our report entitled *HUD's Loan Origination and Foreclosed Property Management Processes* (GAO/AIMD-00-41R, Nov. 19, 1999).

According to HUD's contract-monitoring guidance, the homeownership center staff are to use information from the sources discussed above to prepare a comprehensive analysis of contractors' performance. As part of the analysis, the homeownership center staff assigns a risk rating of low, medium, or high to the contractor's performance on each of 11 dimensions.[6] According to HUD's guidance, a "low risk" rating indicates minor performance problems that can be easily corrected, which means that no more than 5 percent of the properties surveyed resulted in findings of noncompliance.[7] A "medium risk" rating indicates a pattern of findings and/or findings that significantly affect either the Department or the communities that it serves. A "high risk" rating indicates patterns or continual findings that the contractor has failed to correct or findings that have a devastating effect on HUD's assets or the community's interests.

HUD Experienced Widespread Problems With Property Management Contractors' Performance

The primary emphasis of HUD's management and marketing contracts is on getting properties sold. Thus, contractors have been more aggressive at selling properties, using the Internet and broad listing brokers,[8] and using other services to publicize the properties and enhance sales. For example, HUD's Southern California contractor has established customer service offices to work with the realtors in its jurisdiction. However, HUD has experienced widespread problems with its new management and marketing contractors on a variety of fronts. Six of its seven contractors have had significant problems with securing and maintaining the properties assigned to them, and HUD has noted problems with various aspects of the contractors' sales processes. InTown Management Group, for example, which had contracts covering about 40 percent of the properties in inventory, had problems both with property maintenance and sales. HUD, after trying unsuccessfully to secure better performance from this contractor, terminated all of its contracts. HUD selected three of the six remaining contractors to absorb some of the terminated contractor's workload, even though two of these replacement contractors were also

[6]These performance dimensions assess such tasks as claims review, property maintenance, appraisal procedures and monitoring, and sales procedures. (See app. II for a further discussion of the performance dimensions that homeownership center staff are to review.)

[7]The homeownership center staff must justify, in writing, any assessment of low risk where more than 5 percent of the properties surveyed resulted in findings of noncompliance.

[8]The broad-listing broker places each property on a local multiple-listing service and answers inquiries regarding the property.

having performance problems. Although HUD has identified these performance deficiencies, its efforts—such as phone calls and deficiency letters—to enforce contractor's compliance, short of contract termination, have not effectively corrected the problems. HUD has also had difficulties with monitoring its contractors' performance. For instance, HUD's oversight assessments of contractors' performance do not follow a consistent format and do not always determine the level of risk posed by contractors' performance, making it difficult to compare and track the performance of contractors over time.

HUD's Contractors Experienced Performance Problems Since Early in the Contracts' Implementation

HUD's management and marketing contractors experienced start-up problems after being awarded their contracts. Early assessment reports prepared by the homeownership centers to evaluate contractors' performance indicated that most of the contractors had problems with carrying out some of their responsibilities. For instance, the assessment reports for June 1999—3 months after the contracts became effective—indicate that of the 10 contracts reviewed by the centers that month,[9] 8 had high risk performance in at least one of the performance dimensions reviewed.[10] Four of the eight had high risk performance—the potential for adverse impact on the property disposition program or to the communities where the properties are located—in two performance dimensions, two had high risk performance in three dimensions, and one had high risk performance in five dimensions. A review of the monthly assessment reports prepared by the centers as of November 1999, the last month for the reports that we reviewed, indicate that the contractors' performance problems have persisted. The contractors' performance under 11 of the 13 contracts reviewed was high risk in at least one of the performance dimensions.[11] The performance under five of the contracts was high risk in three or more performance dimensions. (See table 1.)

[9]The 10 contracts reviewed include the replacement contractor for the one InTown contract that was terminated in May 1999.

[10]In many of the monthly assessment reports evaluating contractors' performance, HUD staff provided a narrative but no clear statement of their risk determination for each performance dimension. Where there was no risk determination made by HUD staff, we applied HUD's criteria to arrive at the risk level depicted by their findings.

[11]Three contracts were not assessed in November 1999. As table 1 shows, an assessment report was not produced for one contract, another did not have a replacement contractor yet, and the last was split between Philadelphia Homeownership Center staff and two replacement contractors.

Table 1: High Risk Performance Dimensions for Contractors in June and November 1999

Homeownership center and contract area	Contractor's high risk performance dimension(s)[a] in June 1999	Contractor's high risk performance dimensions in November 1999
Atlanta Area 1	Contract area under InTown	Unable to determine. HUD did not produce an assessment report for this contractor in November
Atlanta Area 2	Contract area under InTown	Contract area is the responsibility of the Atlanta Homeownership Center staff until a new contractor can be selected.
Atlanta Area 3	Property Maintenance Property Listing for Sale Procedures	Property Maintenance
Denver Area 1	Property Maintenance Appraisal Procedures and Monitoring Single-Family Acquired Asset Management System Data Entry	Claims Review Property Maintenance Appraisal Procedures and Monitoring
Denver Area 2	Property Maintenance Appraisal Procedures and Monitoring Office Processes and Procedures	Claims Review Property Maintenance Appraisal Procedures and Monitoring
Denver Area 3	Claims Review Property Maintenance Appraisal Procedures and Monitoring Sales Procedures Single-Family Acquired Asset Management System Data Entry	Claims Review Property Maintenance Appraisal Procedures and Monitoring Sales Closing Procedures
Philadelphia Area 1	Property Maintenance	Property Maintenance
Philadelphia Area 2	[b]	None
Philadelphia Area 3	[b]	Property Maintenance Sales Procedures Sales Closing Procedures
Philadelphia Area 4	Contract area under InTown	Philadelphia Homeownership Center staff are responsible for one state in this area and the other three states were assigned to two replacement contractors.
Santa Ana Area 1	Property Maintenance Property Listing for Sale Procedures	Property Maintenance
Santa Ana Area 2	Property Maintenance Appraisal Procedures and Monitoring	Property Maintenance Sales Closing Procedures
Santa Ana Area 3	[b]	Appraisal Procedures and Monitoring
Santa Ana Area 4	None	Claims Review Property Maintenance Tax Payment and Invoice Processing

Continued

Santa Ana Area 5	Property Maintenance Single-Family Acquired Asset Management System Data Entry	Property Maintenance
Santa Ana Area 6	None	None

Continued from Previous Page

[a]See appendix II for an explanation of each of the performance dimensions.

[b]The contract that was in effect for this area as of November 1999 became effective in September 1999. Thus, the June assessment report was for the previous contractor.

One of the areas in which most of the contractors have had particular performance problems is that of property maintenance and security. Contractors' failure to properly secure and maintain the properties assigned to them may cause a decline in property values and have a negative impact on surrounding neighborhoods. In the homeownership center staff's monthly assessment reports of contractors' performance for each month from May through November 1999, the staff's assessments depict high risk performance in terms of property maintenance for over half of the contracts reviewed.[12] Even in the assessment reports for November—8 months after the initial contract start-up period—the homeownership center staff noted that over 60 percent of the properties reviewed in some contract areas were in less than satisfactory condition.

[12]These data exclude the assessment reports related to the InTown Management Group contracts.

Table 2: Property Maintenance Problems Noted by HUD in the November 1999 Assessment Reports

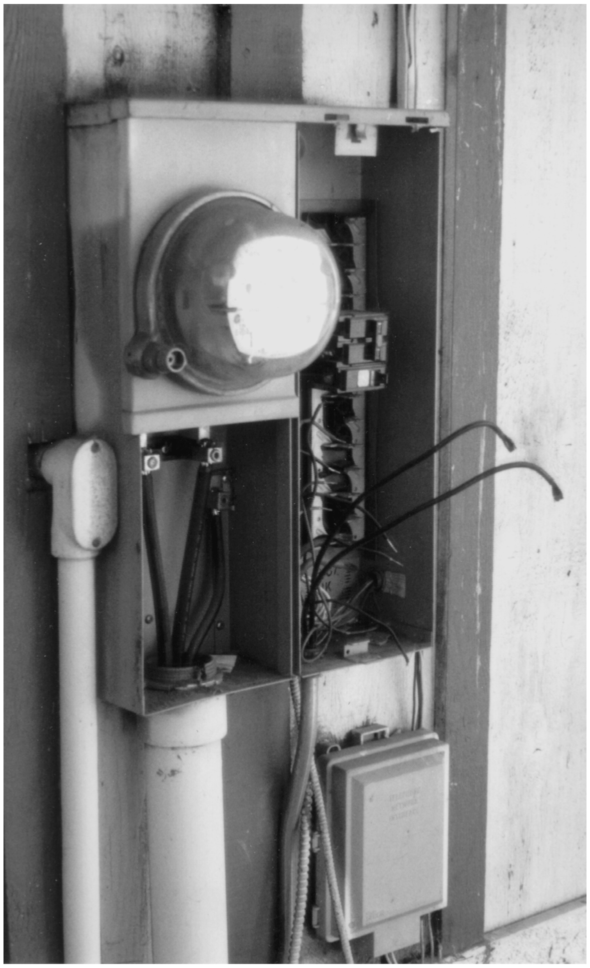
Homeownership center/contract area	Property maintenance problems reported in assessment reports
Atlanta Area 3	Leaking roofs, broken windows, interior debris, exterior debris, unsecured properties, properties not inspected within 24 hours, and missing initial inspection reports.
Denver Area 1	Unsecured properties; lawn maintenance not done; property not clean inside, outside, or both; properties not in presentable condition; vandalism; roof leaks and damage caused by roof leaks; structural damage; no file evidence of corrective action on hazardous conditions or code violations; and missing routine inspection reports.
Denver Area 2	Unsecured properties; broken windows; incompletely boarded windows; lawn maintenance not performed; property not clean inside, outside, or both; properties not in presentable condition; vandalism; roof leaks; no snow removal; and structural damage.
Denver Area 3	Unsecured properties; initial lawn maintenance not done; property not clean inside, outside, or both; properties not in presentable condition; vandalism; roof leaks; no snow removal; and structural damage.
Philadelphia Area 1	Unsecured properties; lawn maintenance not done; property not clean inside, outside, or both; properties not in presentable condition; vandalism; roof leaks and damage caused by roof leaks; structural damage; defective paint; pool not secured; no snow removal; broken windows; water leak in basement; and no entry key.
Philadelphia Area 3	Broken windows; property not cleaned; debris removal needed; property not inspected by contractor; repairs needed; and defective paint.
Santa Ana Area 1	Unsecured properties; property not cleaned inside, outside, or not in presentable condition; vandalism; broken windows; and unsecured pools.
Santa Ana Area 2	Properties not secured; roof leaks; vandalism; property not clean inside or outside; and property not in a presentable condition.
Santa Ana Area 4	Little documentation of ongoing protection and maintenance; completion of authorized repair or maintenance work not documented; and no evidence of follow-up inspections or routine exterior maintenance.
Santa Ana Area 5	Personal property left in home, and structural problems.

We corroborated that these problems existed during our visits to 16 properties. Several of the properties we visited were not properly secured or maintained. For example, one of the homes in Washington, D.C., was poorly maintained (see fig. 3), had an open front window and rear door; beer bottles inside; and, although the grass in the front yard had been trimmed, the backyard was overgrown with brush and weeds. A property in Philadelphia that was listed for sale by the contractor still had the previous maintenance contractor's sign on the front door, unrepaired vandalism along the side of the house (see fig. 4), trash in the rear courtyard, and an unsecured opening into the house. A number of the properties we visited in California had trash left in the yard, had been vandalized (see fig. 5), or had unlocked doors or windows. HUD officials told us that because of the nature of HUD's properties, some of which are in neighborhoods prone to vandalism, they may never be able to keep all properties properly maintained.

Figure 3: Unmaintained Washington, D.C., Property

Figure 4: Vandalized Philadelphia Property

Figure 5: Vandalized Electrical Box on California Property



The homeownership centers have been bringing these issues to the contractors' attention and pressing for changes in the contractors' performance by identifying problems through the monthly assessment reports and by discussions with the contractors. For example, HUD's initial performance assessment reports for InTown, which was awarded the largest number of contracts (7 out of 16) and was assigned about 40 percent of the initial property workload, disclosed problems in almost all performance dimensions for all of the contractor's contracts. In May 1999, HUD terminated the InTown contract covering the states of Iowa, Minnesota, Montana, Nebraska, North Dakota, and Wisconsin and issued deficiency letters on the other six InTown contracts in an attempt to spur corrective action. However, InTown continued to have performance problems with the remaining contracts. On September 22, 1999, HUD terminated all six of InTown's remaining contracts,[13] primarily due to the lack of sales, because at the time its contracts were terminated, InTown had sold only about 9 percent of the properties for which it was responsible.

Contractors' performance problems are also illustrated by the contractor that HUD selected to assume responsibility for Iowa and five other states after HUD terminated the InTown contract. The replacement contractor already had three other contracts at the time that it was awarded the former InTown contract area in May 1999. While HUD relied on this contractor to absorb much of InTown's workload, HUD's assessments had noted serious performance weaknesses with the company's existing contracts. For example, the replacement contractor's performance in two of its existing contracts was high risk for 2 of the 11 performance dimensions assessed by homeownership center staff. Specifically, with regard to property maintenance in one of these contracts, 64 percent of the contractor's properties inspected by HUD staff and third-party contractors were found to be in less than satisfactory condition. With regard to appraisal procedures in that same contract area, almost half of the files reviewed did not have appraisals completed within the required 10 days. According to HUD's guidance, the failure to obtain timely appraisals can cause the Department to incur unwarranted holding costs and could possibly result in the receipt of appraisals that are not accurate.

In the 6 months after the contractor assumed responsibility for the InTown contract, its performance on two of its existing contracts declined even further; the contractor's performance was high risk in two to five of the performance dimensions reviewed each month. The contractor's performance regarding the Iowa contract was even worse; performance was high risk in three to six of the dimensions reviewed each month. For example, the homeownership center staff's assessments of the contractor's performance under one of its contracts from June through September 1999 indicate that at least 60 percent of the properties inspected were maintained in less than satisfactory condition for all 4 months. These findings included deficiencies such as properties that were not secured; properties that were not clean inside, outside, or both; or properties that

[13]HUD has referred the principals of InTown to the Office of Inspector General and the Department of Justice for criminal investigation.

had damage caused by roof leaks. During the same time period, the homeownership center staff also continued to note high risk performance in the area of appraisal procedures. For example, in July 1999, 72 percent of the files reviewed under one of this contractor's contracts contained appraisals that were not received within the required time frame. These problems notwithstanding, when HUD terminated the balance of InTown's contracts in September 1999, it selected this same contractor to handle the contract for Washington, D.C., and five eastern states formerly handled by InTown. In the first 2 months that this new contract was assessed, this contractor's performance was high risk in 3 of 10 performance dimensions for both months.

HUD Has Been Effective in Identifying Performance Problems but Has Limited Tools to Improve Contractors' Performance

While HUD has been effective in identifying performance problems with certain aspects of the contractors' operations, it has not been as effective in correcting them. HUD has made progress in correcting problems that initially surfaced with its monitoring methods, but inconsistencies in the homeownership centers' monitoring practices have made it difficult to compare the property management contractors' performance and to track contractors' performance over time. While the structure of HUD's contracts encourages the sale of properties, experience to date has also revealed limits in HUD's tools to address poor contractor performance in other areas. Finally, HUD's termination of InTown has shown the limits to contract termination as an enforcement option when few contractors are available as replacements.

HUD's oversight methods have certain shortcomings that make it difficult to compare and track contractors' performance over time. Some of HUD's initial monitoring system problems have been associated with the third-party contractors that HUD uses to help oversee the management and marketing contractors. For instance, according to officials in HUD's Santa Ana Homeownership Center, the contractor hired to check the condition of a sample of properties in Southern California was not performing the required inspections and appeared to be falsifying some inspection records. HUD noted that pictures that the contractor claimed it took of properties during its inspections were obviously not of the correct properties. HUD terminated this property inspection contractor for inadequate performance. The Santa Ana Homeownership Center absorbed the contractor's workload while arranging for a replacement. However, because of resource constraints, HUD staff performed fewer inspections than it would require its contractors to perform.

Inconsistencies in the homeownership centers' development and reporting of contractor assessments reduce the usefulness of these assessments for tracking and comparing performance. For instance, according to HUD's monitoring guidance, the monthly assessments are supposed to determine whether the level of performance described under each performance dimension constitutes a low, medium, or high risk. These determinations were reported by the Santa Ana Homeownership Center in assessment reports only for May and June 1999 and by the Denver Homeownership Center for April, June, and August 1999 but have not been reported by any of the homeownership centers for the later months of 1999. In fact, of the assessment reports that we reviewed covering the months of April through November 1999, over 70 percent did not assign risk determinations to the various performance dimensions. In addition, HUD does not use a consistent reporting format—while some assessment reports evaluate the 11 performance dimensions specified in HUD's contract-monitoring guidance, others assess 10 or 12 performance dimensions,[14] and while some assessment reports track monthly statistics such as data on contractors' sales and inventories, others do not. The usefulness of the information presented in the assessment reports also varies. For instance, the October and November 1999 assessment reports for one contractor list such performance deficiencies as unsecured properties and properties with debris that should have been removed but do not give any indication of how many inspected properties had these deficiencies. In addition, assessment reports were not prepared for one contract for the initial 2 months after a new contractor took over an InTown contract.

Additionally, through experience HUD is learning that it has limited means to address poor performance by the contractors. Although the homeownership centers have identified performance problems, have brought them to the contractors' attention, and have pressed for improvements, these actions have not always yielded the improvement desired. For instance, in September 1999, the Department issued a "letter of concern" to one of the contractors regarding the contractor's inadequate progress in maintaining properties in presentable condition. HUD also issued a deficiency letter regarding poor property maintenance to another contractor. While a HUD official told us that neither of these contractors was terminated and that their performance subsequently improved, the assessment reports prepared by homeownership center staff regarding

[14]Some assessment reports included "tax payment and invoice processing" as a performance dimension.

these two contractors' performance show that as recently as December 1999, over half of the properties reviewed for each of these contractors were in less than satisfactory condition. Aside from pointing out deficiencies in the monthly assessment reports, issuing letters of concern or deficiency letters, or taking steps toward contract termination, HUD staff do not have other tools available to address performance deficiencies. For instance, the contracts do not provide for penalties to enforce compliance with the contract terms. As part of its audit of FHA's fiscal year 1999 financial statements, KPMG LLP, in a report on FHA's internal controls, recommended that FHA devise a method of penalizing management and marketing contractors that routinely do not comply with performance requirements.[15] The report noted that penalties would effectively communicate the importance of strictly adhering to HUD's guidelines.

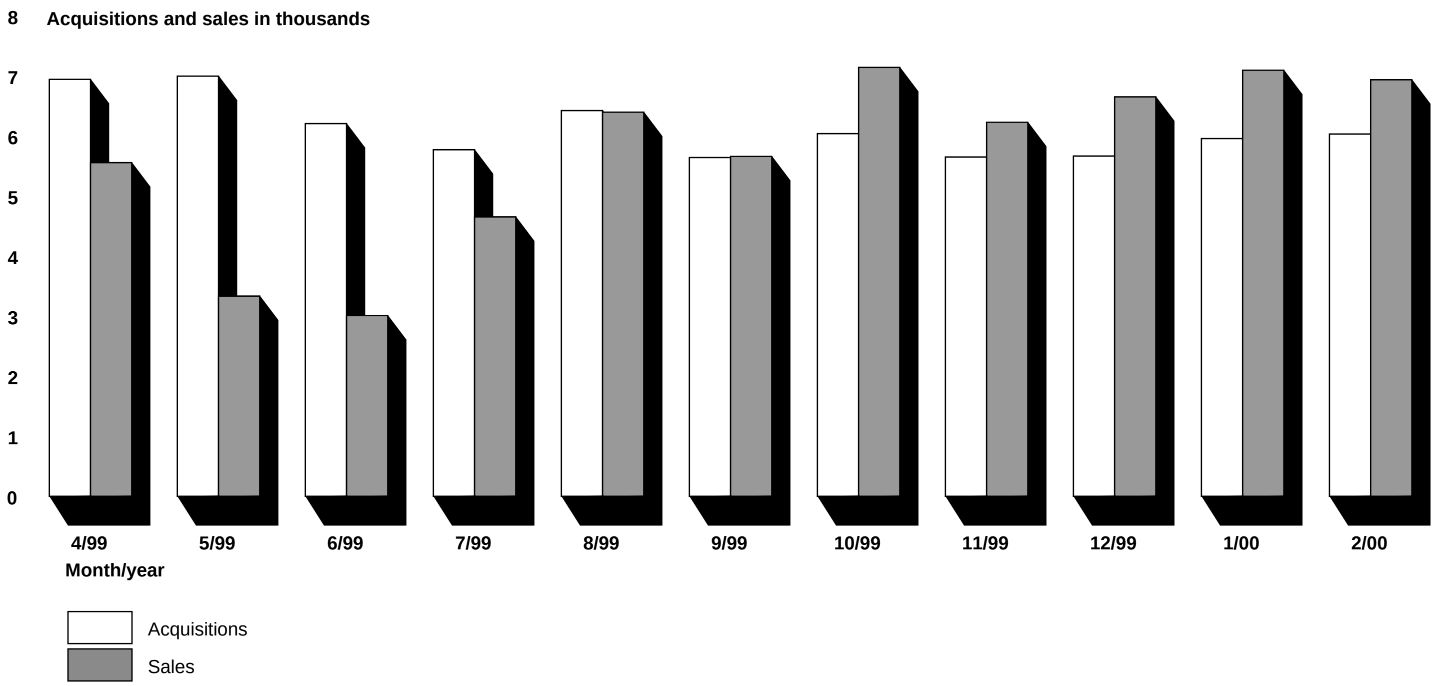
Lastly, HUD's options for absorbing InTown's workload after terminating its contracts were somewhat limited. Although HUD got a large response to its initial solicitation, few contractors were found to be acceptable. HUD evaluated proposals submitted by 49 contractors. However, after screening those 49 contractors for significant weaknesses and/or deficiencies, HUD found only 8 acceptable contractors and 1 capable of being acceptable. HUD selected its seven initial contractors from this group of nine. Prior to InTown's termination, HUD negotiated contingency contracts with three of its existing contractors to take some of InTown's workload. However, the Department was not able to obtain coverage of all the areas by its existing contractors. Therefore, HUD's own staff were designated to handle six of the states formerly covered by InTown until the Department could bring new contractors on board. In November 1999, HUD issued a request for bids to obtain contractors for those six states and, according to a HUD contracting specialist, expects to award the contracts by June 2000.

[15]This report was issued on February 24, 2000, and it is thus too early to assess HUD's actions taken in response to the report's recommendations.

After 3 Years of Increases, HUD's Inventory Is Beginning to Decline, but the Number of Older Properties in the Inventory Is Increasing

In addition to managing the acquired properties, a key component of the contractors' responsibilities is selling these properties. After an increase in the inventory in recent years, the number of properties is now beginning to decline. The management and marketing contractors, hired for their real estate sales expertise, are beginning to increase their sales of newly acquired properties coming into the inventory. (See fig. 6.) As a result, the inventory of properties as of February 2000 is down to approximately 47,000, from a high of 52,000 properties. However, the number of older properties—those in the inventory longer than 6 months—has increased.

Figure 6: Number of New Acquisitions Into the Inventory Compared With Sales by Month Since the Implementation of Management and Marketing Contracts



Source: GAO's analysis of data from HUD.

HUD's Inventory of Properties Has Grown in Recent Years, but Is Now Beginning to Decline

HUD's inventory of foreclosed properties steadily increased during fiscal years 1997 through 1999 but has been declining throughout fiscal year 2000. During fiscal year 1997, HUD acquired 64,000 properties, sold approximately 59,000, and had an ending inventory of 30,000. In fiscal year 1998, the inventory grew to over 39,000 properties; an additional 74,000 properties were acquired and 65,000 sold. In the first 3 months following the implementation of the management and marketing contracts (Apr. through June 1999), the inventory continued to increase as additional properties were acquired and sales declined. For example, in April 1999, HUD acquired about 7,000 properties but sold only about 5,600. (See fig. 6.) By the end of fiscal year 1999, HUD's inventory reached approximately 52,000 properties.

To explain the rise in the inventory, HUD officials told us that property acquisitions were high because of foreclosures while sales were down because of start-up problems experienced by the contractors—particularly InTown's failure to sell properties. According to HUD officials, these start-up difficulties included the contractors' difficulties in using HUD's Single-Family Acquired Asset Management System. In addition, HUD temporarily stopped sales of all its properties in February 1999 in preparation for the transfer to the management and marketing contractors. HUD required the contractors to inspect and reappraise all properties before they could be listed for sale again. HUD officials cited the poor performance of InTown as the main reason for the decline in sales of acquired properties.

By October of 1999, however, the contractors had increased their sales, which, by that time, were outpacing acquisitions. For example, HUD acquired about 6,000 properties in October 1999, while the contractors sold about 7,000 properties. As of February 2000, the inventory was down to about 47,000 properties. The structure of HUD's contracts, which provide full payment to the contractors only after a property is sold, provides an incentive for good sales performance. In addition, since the contractors began selling properties in April 1999, HUD has experienced improvements in some of its sales-related statistics. For example, the average sales time has been reduced by 38 days—from 182 to 144—and the net recovery from sales, the percentage of the home's value that HUD nets after paying all costs associated with managing the property, increased from 79.7 to 80.2 percent.

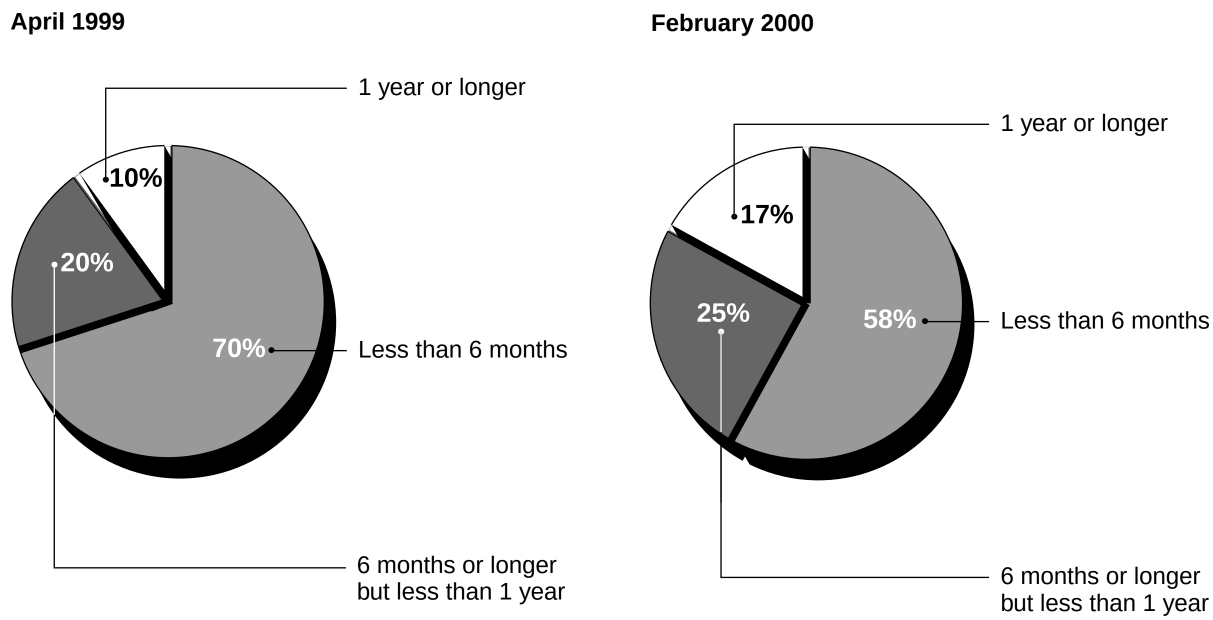
Contractors Are Not Effectively Reducing the Number of Properties That Have Been in the Inventory for 6 Months or Longer

Although the contractors have increased their sales of HUD properties, the inventory of older properties, or those that have remained in the inventory for 6 months or longer, has increased. The contractors are selling more of the newer properties coming into the inventory. In February 2000, almost 20,000 properties were in the inventory 6 months or longer, about 8,000 of these were in the inventory for a year or longer. This is up from about 13,000 properties that were 6 months or older in April 1999, and about 4,400 that were in the inventory a year or longer, when the management and marketing contracts became effective. Properties that were in the inventory for 6 months or longer accounted for 42 percent of the total inventory at the end of February 2000—up from 30 percent in April 1999. The properties in the inventory for 1 year or longer increased from 10 to 17 percent of the total inventory for this same time period. According to a HUD-contracted study,[16] in the real estate industry, only about 2 to 3 percent of the properties remain in the inventory for over a year. According to the responsible HUD Division Director, the longer a property remains unsold, the higher the likelihood that it deteriorates or is vandalized. Deteriorating properties can have a negative impact on the surrounding community and the market value of nearby homes. In 1995, we reported that properties in the inventory for longer periods of time are sold for proportionately less.[17]

[16] *Industry Benchmarking and Best Practices Report*, U.S. Department of Housing and Urban Development, Single-Family Property Disposition, Business Process Reengineering, Andersen Consulting (Mar. 27, 1997).

[17] See *Property Disposition: Information on HUD's Acquisition and Disposition of Single-Family Properties* (GAO/RCED-95-144FS, July 24, 1995).

Figure 7: Percentage of Properties by Length of Time in HUD's Inventory in April 1999 Compared With Percentage in February 2000



Source: GAO's analysis of data from HUD.

HUD is aware of the problems with older properties in the inventory, but its efforts to address the issue have not been effective. HUD's headquarters encourages the contractors, through frequent telephone calls, to focus on the older properties. HUD officials told us that they have not yet begun to lower the sales price of the older properties to encourage sales.[18] Although, HUD has an extensive monitoring system to oversee contractors' performance, the system does not specifically address contractors' performance in selling aging properties. Thus, there are no specific incentives for the contractors to give attention to the older, potentially more difficult to sell properties, or penalties if they do not. In contrast, the fee structure of the contracts provides an incentive for the contractors to sell properties quickly, which could lead the contractors to sell the newer,

[18]On March 1, 2000, HUD announced a new Good Neighbor Program where it will sell properties that have been listed for over 6 months to local communities for $1. The program is too new for us to know what effect it may have on HUD's inventory of older properties or on the fund.

more marketable properties first. While selling properties quickly is desirable, the older properties should not be allowed to deteriorate.

Conclusions

After a disappointing start with the forced termination of its largest contractor, HUD and the remaining management and marketing contractors have begun to increase sales. HUD's contracts provide incentives to sell properties quickly. However, HUD has found that other performance deficiencies persist on the part of many of the contractors, especially in the area of property maintenance. HUD requires the contractors to secure and maintain the properties that remain in the inventory so that they are not blights to the surrounding neighborhoods and so that they can be sold at their maximum values. HUD recognizes the importance of maintaining and securing its properties and assesses the performance of the contractors on this basis. However, given the continuing problems that HUD, KPMG, and we have identified with property maintenance and security, HUD's available incentives and enforcement methods, short of contract termination, are not strong enough to ensure that the contractors are meeting their responsibilities in this area. In its internal control report as part of its fiscal year 1999 audit of FHA's financial statements, KPMG recommended that HUD needs to devise a method of penalizing management and marketing contractors that routinely do not comply with contract performance requirements. We agree that a more effective mix of incentives and penalties is needed.

Although HUD's inventory of properties has begun to decline, there has been little emphasis on properties that have been in the inventory for a long period of time. These properties tend to worsen the longer they remain unsold and could possibly sell at a lower price than other properties in the inventory. HUD's management and marketing contracts are focused primarily on selling properties quickly and do not provide contract incentives or penalties that could be used to focus more attention on HUD's older properties. By not effectively addressing the aging of its inventory, HUD may be allowing deteriorating properties to have a negative impact on the value of surrounding properties and on the communities and may not be accomplishing its goal of achieving a maximum return for its insurance fund.

Recommendations

To improve the effectiveness of HUD's property disposition program, we recommend that the Secretary of Housing and Urban Development direct the Assistant Secretary for Housing-Federal Housing Commissioner to develop more effective methods, such as specific incentives or penalties, to encourage contractors to reduce the number of properties that are in the inventory longer than 6 months.

Agency Comments

We provided HUD with a draft of this report for review and comment. While HUD agreed with some of our findings and disagreed with others, it did not express a view on our draft report's recommendation.

In commenting on the performance of the management and marketing contractors in general, HUD presented a number of recent sales-related statistics and asserted that they prove the success of the management and marketing contracts. HUD also stated that property maintenance under the management and marketing contracts is better, since sales have increased. Lastly, HUD stated that our draft report did not consider most of the common real estate performance measures such as the overall volume of sales, the financial return on sales, the amount of time that properties are held in inventory, and the percentage of properties sold to owner occupants in assessing the contractors' performance. Contrary to HUD's comment, our draft report did address common real estate performance measures such as the number of homes sold, the net recovery from sales, and the average sales time. In addition, our draft report recognized the recent increase in sales and the improvement in sales-related statistics. We also used HUD's performance measures set out in its guidance for assessing the performance of the contractors. As we report, HUD's monthly assessment reports, which use these measures, show continued contractor performance problems—particularly with property maintenance. Lastly, while property sales are important, we believe that the contractors should be held accountable for managing the properties as well as marketing.

HUD commented that our draft report's discussion of contractors' performance did not reflect two critical aspects of its monitoring approach. First, HUD stated that while it expects contractors to comply with every contract requirement, it noted that the degree of financial risk to the Department from noncompliance is much greater for some requirements than others, which results in varying actions from HUD. Second, HUD stated that the contractors' sales performance and its contractor assessment reports indicate that HUD's corrective actions have resulted in improved performance by all the contractors except InTown. Our draft report did not distinguish between the different types of noncompliance or prioritize HUD's performance measures because HUD's guidance does not draw any distinction or priority between the different required performance measures it uses to assess the contractors. During our review, HUD officials acknowledged that they had not established a priority ranking of the contractor performance measures. In addition, our draft report concentrated on property maintenance in discussing contractors' performance problems because we believe this is one of the key performance measures in that it affects the value of the property, the ability of the contractor to market the property, and the property values of the surrounding community. Furthermore, as our draft report stated, our analyses of the monthly assessment reports show that most contractors had performance problems that continued, and in some cases worsened, for the period we reviewed.

HUD agreed with our draft report's finding regarding inconsistencies in the homeownership centers' monitoring of the contractors. HUD stated that to address this problem, it had scheduled additional training for contract monitors in July 2000.

HUD disagreed with our conclusion that the Department had limited enforcement tools to address contractors' performance deficiencies. HUD stated that it had an array of enforcement tools at its disposal and had demonstrated a willingness to use them. Our draft report recognized HUD's use of assessment reports, letters of concern or deficiency letters, and contract terminations to address contractors' performance problems. However, our draft also pointed out that the contracts do not provide for penalties to enforce compliance with the contract terms. As a result, HUD has had limited success in improving the poor performance of its management and marketing contractors. As our draft report noted, two contractors to whom HUD issued letters of concern or deficiency letters in September 1999 showed continued and serious deficiencies in their maintenance of properties 3 months later. Moreover, our draft report showed that as of November 1999, the contractors' performance under 11 of the 13 contracts was determined to be "high risk" in at least one of the performance dimensions.

In commenting on our draft report's discussion of its inventory of properties, HUD stated that its inventory of homes has been declining for 9 straight months and that this trend should continue. Although we reviewed a different time period in our analysis—April 1999 through February 2000—our draft report acknowledged that the inventory was beginning to decline at the end of fiscal year 1999 as sales began to outpace acquisitions. We also recognized that the slowdown in sales in April of 1999 was due to

HUD's activities related to the transfer of properties to the contractors, such as requiring the contractors to inspect and reappraise all of the properties. We also cited InTown's poor performance as one reason for declining sales at the beginning of the transition to the management and marketing contractors.

With regard to our draft report's discussion of HUD's aged inventory of properties, HUD noted that the inventory of these properties recently declined from a high of 21,059 in December 1999 to 16,368 by April 2000. While we view this as a positive sign, we note that the aged inventory as of April 2000 is still higher than it was a year ago. Our draft report also noted HUD's plan to sell aged properties at reduced prices to local communities under its Good Neighbor Program. However, with an implementation date of May 1, 2000 for the program, it was too early for us to review the program or determine its effect on the aged inventory. Considering the large number of aged properties and the effect that they can have on the surrounding community, we still believe that HUD needs more effective measures to encourage contractors to reduce the number of properties in the inventory for over 6 months.

The full text of HUD's letter is presented in appendix I.

Scope and Methodology

To determine HUD's experience with the contractors who manage and market its inventory of acquired properties, we obtained information on the number of single-family properties acquired by HUD, property sales, and inventory balances for 1996 through 1999. We also reviewed HUD's statement of work for the management and marketing contracts and the guidance provided to the homeownership center staff for monitoring the contracts. We interviewed the Director of HUD's Single-Family Servicing Division and officials at the Philadelphia, Pennsylvania and Santa Ana, California Homeownership Centers, which have a large portion of HUD's single-family property inventory. In addition, we interviewed officials from three of the contractors operating in the jurisdiction of these homeownership centers. We also reviewed prior reports on this issue by HUD's Office of Inspector General.

To supplement our review of HUD's and its contractors' practices and processes, we visited and observed 16 homes in the Washington, D.C., Philadelphia, Chicago, and Dallas areas. Ten of these homes were selected from a nationwide statistical sample of foreclosed properties developed for our 1999 review of HUD's foreclosed property management process. We also visited six homes selected from a random sample of homes in Fontana, California. We limited our selection to the homes that had not been sold and were thus still being managed and marketed by the contractor.

To determine the current status of HUD's management and marketing contracts, we interviewed HUD's chief procurement officer and his staff. We obtained and reviewed all of HUD's contractor assessment reports for April through November 1999. Our primary focus in this analysis was on the risk determinations—assessments of the extent of performance problems—made by HUD's staff with regard to the contractors' performance on each of the 11 performance dimensions. In those cases where HUD provided an explanation of the extent of performance problems but did not label them as a low, medium, or high risk, we applied HUD's criteria to arrive at the risk level depicted by their findings.

We conducted our review from July 1999 through April 2000 in accordance with generally accepted government auditing standards.

As arranged with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Honorable Barney Frank, Ranking Minority Member, Subcommittee on Housing and Community Opportunity, House Committee on Banking and Financial Services; the Honorable James A. Leach, Chairman, and the Honorable John J. LaFalce, Ranking Minority Member, House Committee on Banking and Financial Services; the Honorable John Kerry, Ranking Minority Member, Senate Subcommittee on Housing and Transportation; the Honorable Susan M. Collins, Chairman, and the Honorable Carl Levin, Ranking Minority Member, Senate Permanent Subcommittee on Investigations; the Honorable Phil Gram, Chairman, and the Honorable Paul Sarbanes, Ranking Minority Member, Senate Committee on Banking, Housing, and Urban Affairs; and the Honorable Fred Thompson, Chairman, and the Honorable Joseph Lieberman, Ranking Minority Member, Senate Committee on Governmental Affairs. We will also send copies of this report to the Honorable Andrew M. Cuomo, Secretary of Housing and Urban Development; the Honorable William C. Apgar, HUD Assistant Secretary for Housing-Federal Housing Commissioner; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will make copies available to others upon request.

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

Stanley J. Czerwinski
Associate Director, Housing and
Community Development Issues

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

MAY 2 2000

Mr. Stanley J. Czerwinski
Associate Director, Housing and Community
Development Issues
United States General Accounting Office
Washington, DC 29548

Dear Mr. Czerwinski:

The Department appreciates the opportunity to respond to the General Accounting Office's (GAO) report on the performance of the Federal Housing Administration's (FHA) Management and Marketing (M&M) contractors to date. Since assuming responsibility for all property management and marketing activities approximately one year ago, FHA's M&M contractors have performed extremely well by any measure commonly used in the real estate industry to evaluate performance. Like other organizations in the real estate industry, HUD uses a variety of factors and measures to evaluate REO property management and sales performance, including: overall volume of sales, financial return on sales (measured both by gross property sales price and recovery as a percentage of the mortgage insurance claim), time properties are held in inventory prior to sale, and the percentage of properties sold to owner occupants. Data provided by HUD to GAO comparing property sales performance from April, 1998 through January, 1999 under the old system, with sales experience from April, 1999 through January, 2000, under the new initiative demonstrates that the M&M contractors are:

- **Selling HUD Homes much faster than HUD staff did under the old system**. HUD's M&M contractors have reduced the average time properties are held in inventory to 144 days, compared to approximately 180 days one year ago;

- **Increasing the financial return to HUD and the federal government**. Under the M&M contractors the average sales price on HUD homes has increase by more than 19 percent, and the overall recovery as a percentage of the mortgage insurance claim has increased by nearly 10 percent, representing average savings of $4,500 per property sold. Based on total sales to date (68,000 through April, 2000), the aggregate savings under the program is $306 million;

- **Selling many more homes than HUD did under the old system**. In the first six months of this current government fiscal year, from October, 1999 through March, 2000, HUD's M&M contractors sold 42,811, compared to sales of just 33,815 homes -- a 27 percent increase in the number of homes sold. These trends continued throughout April, 2000 when over 7,500 homes were sold;

- **Increasing the percentage of HUD homes sold to owner occupants**. Nearly 70 percent of all sales by M&M contractors are going to owner occupants, compared to just 58 percent of all sales under the old system.

HUD's M&M contractors also have improved the level of property maintenance compared to the old system. Although HUD field staff have identified some specific isolated geographic areas where maintenance has not met HUD's standards, the M&M contractors (with the exception of InTown Management Group (ITMG)) have demonstrated the ability to quickly implement corrective actions and address these deficiencies in response to HUD's assessments. Moreover, the best indication of the M&M contractors improved property maintenance is the market's positive response to HUD homes over the last year. Market indicators, such as a faster pace of sales and higher returns on HUD Homes, clearly indicate that the market has determined that HUD Homes are a better product today than they were one year ago, prior to implementation of the M&M initiative.

Curiously, GAO does not consider or address most of these common real estate performance measures in their report. Despite the fact that HUD staff spent several days briefing the GAO review team and providing data to support all of the performance measures described above, the draft GAO report presents a limited understanding and portrayal of HUD programs specifically, or the real estate industry generally.

FHA Has Successfully Implemented a Comprehensive Contract Monitoring System

Instead of employing common real estate industry measures to evaluate FHA's M&M contractors' performance to date, GAO raises a number of questions about the effectiveness of FHA's contract monitoring practices. HUD finds this criticism puzzling in light of the tremendous success all four FHA Home Ownership Centers (HOCs) have had in implementing a comprehensive contract monitoring system over the last year. This new system, designed in collaboration with the management consulting firm Booze, Allen & Hamilton, calls for HUD field staff and contract monitors to:

- inspect the physical condition of 10 percent of all properties in inventory on a monthly basis;
- audit 10 percent of all M&M contractor case files on a monthly basis;
- complete on-site process observations at the M&M contractor's offices, on a monthly basis;
- conduct daily analysis of property listing and sales reports;
- prepare comprehensive contractor performance assessment reports for each contract area; and,
- hold monthly performance reviews with the contractors to assess critical performance measures, identify deficiencies and direct corrective actions, on a monthly basis.

As the GAO report clearly indicates, each HOC is following these procedures and is producing an unprecedented amount of information on contractors' performance. In just twelve months time HUD field staff have aggressively adopted and implemented this unparalleled, comprehensive contract monitoring system.

The GAO report appropriately cites performance issues raised by HUD contract monitors with virtually every M&M contractor as part of monthly contract reviews. With substantial detailed information at their fingertips, HUD staff have been able to pinpoint performance problems when they inevitably arise and implement specific corrective actions to enhance performance. In implementing this new initiative, HUD has deliberately held the contractors to very high standards. The Department has raised the bar on its expectations for contractor performance over the last twelve months, and this attitude has paid tremendous dividends, as the overwhelmingly positive performance numbers above indicate. HUD attributes a great deal of the success to date with the M&M initiative to its aggressive contractor monitoring program.

The Department is rightfully proud of this aggressive monitoring approach, and will continue to insist on contractor improvement in all aspects of contract requirements, from complete file documentation to oversight of sales closings. However, HUD also believes that GAO fails to understand two critical aspects of HUD's monitoring program:

- First, while the Department expects compliance with every requirement in the contract, each assessment category poses a separate and distinct degree of risk to the Department. For example, a contractor who fails to maintain required documentation is absolutely in non-compliance with HUD requirements. However, if the same contractor fails to comply with HUD requirements for acceptable bid thresholds, the risk to HUD of monetary loss due to this type of non-compliance is much higher than documentation shortcomings, and accordingly warrants much more severe action. The GAO review team failed to draw this distinction, and instead appears to put equal weight on all performance factors.

- Second, there is every indication, as again noted in the sales performance cited above and in the Department's more detailed performance measures, that the contract control structure employed by HUD has resulted in corrective actions and improved performance by contractors other than ITMG. In tracking a number of different daily and monthly performance reports HUD can point to deficiencies noted in one month's report, coupled with improvements in performance for the following reporting periods. The successful collection and analysis of the information outlined above has had a direct and immediate impact in enhancing contractor performance.

HUD Is Taking Measures to Enhance M&M Contract Monitoring

Still, despite the fact that all four HOC's are accurately collecting all information required of HUD's ambitious contract monitoring plan, the GAO report appropriately notes inconsistencies in presentation of monitoring information across different contract jurisdictions. The Department acknowledges some inconsistency in areas such as the format for monthly assessments, and the distinction which must be made between the inherent risk in managing and selling foreclosed properties and the risk of contractor non-performance. HUD has scheduled additional training in July, 2000 for contract monitors, to help ensure compliance with the existing reporting format. Further, the Department will provide guidelines to all of its monitors regarding measurement of risks inherent in meeting its social mission (e.g., vacant properties in poor neighborhoods are susceptible to damage due to vandalism) versus operational risk (e.g., contractors' obligations to periodically inspect properties, and correct acts of vandalism such as broken windows). The lack of detailed risk assessment guidelines has sometimes resulted in overstatements of relative risk or failure to make a risk determination. The Department considers this a "lesson learned" in implementing a more comprehensive management control structure, and is committed to improvement in this area.

HUD Has a Full Set of Contract Enforcement Options

HUD finds GAO's conclusion that the Department has limited and insufficient enforcement tools to improve contractor performance in direct contrast with several other findings contained in the report. As the report notes, M&M contracts are performance-based, with the contractor fee set as a percentage of the sales price, and all payments tied to achievement of performance milestones. Contractors are only paid when they successfully list and sell properties. In this manner, M&M contractors have strong financial incentives to properly maintain and promptly sell all properties for the full market value. Any failure to maintain properties will only delay sales, create additional costs to the contractor and ultimately diminish the property sales price and the corresponding contractor fee. Therefore, the contract structure, which was developed with substantial input from the HUD Office of Inspector General (OIG), provides the best enforcement mechanism available – substantial financial incentives to fully comply with contract requirements. Moreover, failure to perform also can result in HUD not exercising any of the four one-year options contained in these contracts.

In addition to a smart, incentive-based contract structure, HUD has a full array of other enforcement tools at its disposal to address performance deficiencies. To date, HUD has demonstrated a clear willingness to use this complete set of enforcement options to enhance contractor performance. In just over one year of administering the new M&M initiative, HUD can point to several different examples where formal contracting enforcement actions, including Letters of Concern and Deficiency Notices, have resulted in improved performance. The contractor responsible for the six state New England region demonstrated a dramatic improvement in property listings and sales following a Deficiency Notice for shortcomings in these areas. Other contractors have demonstrated improved property maintenance and sales performance following similar notifications.

Finally, perhaps the most striking example of FHA's effective contract monitoring and enforcement system is the termination of Intown Property Management's (ITMG) contracts. After less than six months of poor performance FHA had gathered sufficient detailed performance information to sustain termination of all six contracts and debarment of all three ITMG principles from government work for a ten year period. This is the type of aggressive contract oversight which HUD has in the past been accused of failing to undertake. The Department is committed to ensuring the integrity of its programs, and will take action against anyone, be it a contractor or a HUD employee, who threatens that integrity.

Moreover, the ITMG terminations and subsequent careful implementation of a combination of new "takeover" contractors and special teams of HUD staff to directly manage a small portion of the HUD inventory, have generated substantial improvements in overall performance. As the chart below demonstrates, this tough enforcement action has boosted FHA property sales activity by more than 800 percent over the last six months.

HOC	Area	States	ITMG Sales 4/99 to 9/99	New Contractors Sales 10/99 to 3/00
Atlanta	Area 1	IL, IN, KY, TN	548	4,708
	Area 2	NC, SC, GA, AL, MS	545	3,220
Philadelphia	Area 2	MI, OH, WV	121	1,817
	Area 3	NY, PA, NJ, DE, VA, DC	495	7,379
	Area 4	MD	373	1,716
Santa Ana	Area 3	WA, OR, ID	184	871
		TOTAL	**2,266**	**19,711**

After selling just approximately 2,200 properties in the first six months of the new initiative under ITMG, under the "takeover" contractors FHA has sold nearly 20,000 homes in the six months since HUD took enforcement action and implemented the takeover plan.

HUD's National Inventory of Homes has Been Declining for Nine Straight Months

After experiencing an increase in the number of HUD Homes nationwide during the initial transition to the M&M system, HUD's national inventory has been declining steadily for the last eight months. At the start of the M&M initiative, HUD directed M&M contractors to re-inspect, re-secure, re-appraise, and re-list every property assigned to them, in order to correct past deficiencies in these areas. This activity, combined with performance failures by Intown Management Group, resulted in a temporary growth in the on-hand portfolio over the first four months of the new initiative. However, since the national inventory peaked in July, 1999, the total number of HUD Homes nationwide has been decreasing steadily. In fact, for each of the last nine months through April, 2000, HUD has sold more homes than it has taken in through claim conveyances. Moreover, since August, 1999 the national inventory has decreased by more than 11,000, a 21 percent decline.

Looking forward, FHA is poised to continue this rapid decline in inventory. As of the end of April, 2000 more than 48 percent of the total inventory, or over 20,600 properties, were under a sales contract or had an acceptable offer from a new home owner. With the typical sales contract required to close within 60 days, FHA is positioned to experience an even more dramatic decline in total inventory over the next two months. Sales data demonstrating these same trends over the last several months were provided to the GAO review team. However, for reasons that are not clear to HUD, GAO has not acknowledged the data.

HUD's Aged inventory is Declining

HUD's internal monthly reports, which were provided to GAO, show that approximately two-thirds of the aged inventory had formerly been maintained by ITMG. Therefore, it is clear that ITMG's dramatic failure to sell HUD Homes during the approximately six months it was under contract with the Department is the primary cause of the growth in aged inventory. Not surprisingly, the takeover contractors and HUD special units managing contract areas formerly under ITMG's control now are starting to show progress in disposing of these difficult to sell properties. After reaching a high of 21,059 properties in December, 1999, just three months after ITMG was terminated, the number of HUD Homes in inventory more than six months had declined to approximately 16,368 by April, 2000, a decrease of more than 22 percent. Further, contractors also are positioned to dramatically reduce the inventory of properties in inventory over twelve months. A recent HUD analysis shows that 53 percent of all properties in this category currently are under a sales contract and will be sold to new homeowners in less than 60 days. HUD expects these positive trends to continue over the next several months.

Moreover, on May 1, 2000 HUD launched the good Neighbor Program -- an innovative program designed to sell aged inventory that has been listed for sale on the open market for more than six months but is not under a sales contract to local governments for $1. Through this program, HUD is partnering with local governments to put these difficult-to-sell properties to good use in promoting community revitalization. In exchange for the discounted sales price, local governments must commit to put the properties to some public use – possibly including rehabilitation and resale to first-time home buyers, low- or moderate-income families, or other targeted beneficiaries.

7

Conclusion

While the Department notes that many of the conclusions in the report were not well founded or were actually contradicted by other findings, we wish to acknowledge that the GAO project lead for this effort had to be replaced in the course of the review, and much of the documentation provided earlier by HUD had to be duplicated. This certainly strained the ability of the review team to complete a well-structured assessment of HUD's Management and Marketing contracts. Nevertheless, it is disappointing that clear indicators of successful managment controls and contractor performance were ignored by the review team. The Department encourages GAO to use the facts on contractor performance already available to reconstruct this analysis.

Sincerely,

William C. Apgar

William C. Apgar
Assistant Secretary for Housing/Federal Housing Commissioner

Contractors' Performance Dimensions to Be Reviewed by Homeownership Center Staff

According to the Department of Housing and Urban Development's (HUD) monitoring guidance, homeownership center staff are to assess the following 11 dimensions in order to evaluate the management and marketing contractors' performance:

1. *Claims Review*: This performance dimension encompasses such objectives as ensuring that the contractor inspects properties within 24 hours of acquisition and reconciles the inspection reports with the claims filed by the mortgagees to confirm that the mortgagees completed all maintenance and repair actions for which they requested reimbursement. According to HUD's guidance, the primary risk associated with this performance dimension is that the contractor will not initially inspect the properties within the 24-hour time frame, which threatens HUD's ability to enforce the mortgagee's responsibilities to preserve and protect the Department's assets until the property is transferred. Another of the risks mentioned in HUD's guidance is that, should the contractor fail to review the reimbursement claim from the mortgagee, the Department could pay for items not completed or completed incorrectly by the mortgagee.

2. *Property Maintenance*: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligation to secure and maintain all of the properties for which it is responsible, ensuring that the contractor is performing routine inspections of its assigned properties and that the properties are secured, and ensuring that proper notifications are made to inform local authorities of HUD's ownership interest in the property. According to HUD's guidance, the risks associated with this dimension are that the contractor's failure to promptly perform the property maintenance functions may result in declines in property values, adverse impacts on the communities where the properties are located, and health and safety hazards to the community.

3. *Appraisal Procedures and Monitoring*: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligations to (1) obtain appraisals within 10 days of a property's acquisition and (2) ensure that the appraisal value is appropriate and reflects true market value. According to HUD's guidance, the primary risk associated with this dimension is that the contractor will influence the appraiser to underestimate the market value to facilitate a quick sale of a property, which could diminish the sale price and result in a lower return on sale to HUD. Another risk

mentioned in HUD's guidance is that the contractor's failure to obtain timely property appraisals will cause the Department to incur unwarranted holding costs and could possibly result in the receipt of appraisals that are not accurate.

4. *Property Listing for Sale Procedures*: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligation to list properties for sale, ensuring that the listings are done in accordance with contract requirements, and ensuring that the contractor is displaying accurate and consistent information on all properties across all methods of advertising. According to HUD's guidance, the primary risk associated with this dimension is that the contractor will not follow contract requirements for listing properties, which could result in listing properties below market value, thus causing a financial loss to the Department. Another risk mentioned in HUD's guidance is that the contractor's failure to perform in accordance with the contract requirements when listing the property for sale could cause the Department to incur additional costs if the property is not properly inspected and listed for sale.

5. *Sales Procedures*: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligation to appropriately accept offers on the properties listed for sale, ensuring that the contractor is using electronic bidding, and ensuring that the contractor is accepting the highest acceptable offers within the thresholds established in its contract. According to HUD's guidance, a primary risk associated with this dimension is that the contractor will accept unnecessarily low offers on the properties in an attempt to facilitate quick sales. Doing so not only presents a risk to HUD's financial returns, but also affects the communities where the properties are located because it could give the perception to the real estate industry and to the public that HUD is only interested in "dumping" its properties quickly without attaining the highest net return possible.

6. *Sales Closings*: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligation to close property sales within established time frames (30 to 60 days), ensuring that the contractor is forwarding complete and accurate closing documents to HUD's closing agents, and ensuring that the sales closings are handled by HUD's closing agents and the proceeds are received by HUD as soon as possible following sales closings. According to HUD's guidance, numerous risks to the Department are

associated with this dimension. For example, delayed sales closings could cause the Department to incur undue holding costs and increase the chance of vandalism or damage to properties, resulting in a potential loss of revenue to the Department.

7. *Single-Family Acquired Asset Management System* (SAMS) Data Entry: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligation to perform daily data entry into SAMS and ensuring that the data in SAMS correspond to the current status of each property. According to HUD's guidance, a primary risk associated with this dimension is that the contractor will not maintain the SAMS database or intentionally misrepresent the information in the system, which could leave the Department unable to determine the value of its assets and the number of properties of which it must dispose.

8. *Rental Process*: This performance dimension encompasses such objectives as determining if the contractor is meeting its obligation to maintain rental properties in accordance with the lease requirements, ensuring that the contractor is collecting rental income on a monthly basis and depositing it as appropriate, and ensuring that the monthly rents charged are based on fair market rental values. According to HUD's guidance, the primary risk associated with this dimension is the loss of rental income if the contractor does not perform this function in accordance with contract requirements.

9. *Occupied Conveyance Process*: This performance dimension encompasses such objectives as determining if the contractor is correctly processing occupied conveyance requests (requests for occupants to remain in a property following its transfer to HUD), ensuring that the contractor is inspecting any properties for habitability when an occupied conveyance request has been received from the occupant, and ensuring that the contractor is establishing a fair market rent that is based on the rents in the area. According to HUD's guidance, a risk associated with this dimension is that the contractor will not comply with the contract requirements and prevent potentially eligible occupants from remaining in a property for a limited period of time.

10. *Defective Paint Issues*: This performance dimension encompasses such objectives as ensuring that a Certification of Inspection for Defective Paint Surfaces is on file for any property constructed prior to 1978 and

ensuring that any defective paint treatment is performed satisfactorily. According to HUD's guidance, a primary risk associated with this dimension is that if a property where defective paint has been detected is purchased by homeowners with children under the age of 7, the contractor's failure to treat the defective paint surfaces could result in harm to the children. Another risk mentioned in HUD's guidance is that if the contractor fails to perform repairs necessary to correct defective paint, the sale of the property may be affected, causing it to remain in inventory for a longer period of time.

11. *Process Observation*: This performance dimension encompasses such objectives as determining if the contractor is meeting the entire contractual obligation to perform management and marketing functions, ensuring that the contractor's key personnel have not changed without prior approval by HUD staff, ensuring that the contractor has developed a written procedures manual for its employees to follow, and ensuring that the contractor is inspecting the work of its subcontractors. According to HUD's guidance, the primary risk associated with this dimension is that the contractor will not properly perform the functions of the contract, thus resulting in a loss of revenue to the mortgage insurance fund, possible vandalism to HUD's properties, and an adverse impact on communities where properties are located.

GAO Contacts and Staff Acknowledgments

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