

GAO

Report to the Chairman, Subcommittee
on Housing and Transportation,
Committee on Banking, Housing and
Urban Affairs, U.S. Senate

January 2004

SINGLE-FAMILY HOUSING

Cost, Benefit, and Compliance Issues Raise Questions about HUD's Discount Sales Program



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Highlights of [GAO-04-208](#), a report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing and Urban Affairs, U.S. Senate

SINGLE-FAMILY HOUSING

Cost, Benefit, and Compliance Issues Raise Questions about HUD's Discount Sales Program

Why GAO Did This Study

In 2001, the Department of Housing and Urban Development's (HUD) Inspector General reported on serious problems in HUD's Discount Sales Program, under which nonprofit organizations purchase HUD-owned properties at a discount, rehabilitate them, and resell them to low- and moderate-income homebuyers. The objectives of the program are to expand affordable housing opportunities, help revitalize neighborhoods, and reduce HUD's property inventory in a timely, efficient, and cost-effective manner. Although the Inspector General recommended that the agency suspend the program and evaluate its viability, HUD did neither. GAO was asked to assess (1) the costs of the program to HUD, (2) the benefits of the program to homebuyers, and (3) HUD's efforts to monitor participating nonprofits and enforce program requirements.

What GAO Recommends

GAO recommends that HUD (1) evaluate options to improve the program's benefit to homebuyers, the agency's monitoring of nonprofits, and enforcement of excess profits requirements; (2) assess the extent to which the program is meeting its objectives; and (3) terminate the program if its current cost plus the resources needed to improve it exceed the program's benefits. HUD agreed with GAO's recommendations to evaluate the program but said that the report overstated the program's costs and understated its benefits. www.gao.gov/cgi-bin/getrpt?GAO-04-208.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at (202) 512-8678 or woodd@gao.gov.

What GAO Found

GAO found that the Discount Sales Program poses significant costs to HUD, is of questionable benefit to homebuyers, and has serious monitoring and compliance problems. GAO estimates that the program cost HUD between \$18.8 and \$23.9 million in calendar year 2002. Between \$15.1 and \$20.2 million was a reduction in net revenue resulting from HUD's selling approximately 1,200 properties through the program instead of through its regular sales process. Personnel expenses for administering the program accounted for the remaining \$3.7 million. GAO's analysis of 238 properties sold under the program in 2002 suggests that most of the homebuyers did not benefit financially. Assuming that nonprofits and homebuyers would incur the same rehabilitation costs, GAO estimates that 76 percent of the homebuyers would have spent less purchasing the properties through HUD's regular process and paying for the rehabilitation work themselves. And while the program can help homebuyers access a range of homeownership services, these services are also available from other sources. GAO did not evaluate the extent to which the program generated other benefits, such as neighborhood revitalization.

While uncovering numerous program violations, HUD's monitoring efforts have faced challenges. For example, HUD monitors nonprofits through desk reviews of the annual reports it requires nonprofits to submit each February. However, as of July 2003, HUD's four homeownership centers, which administer the program, had not received reports for more than half of the properties the agency estimates were purchased and resold under the program in 2002. Even with this problem, the desk reviews found that 28 of the 44 nonprofits that submitted reports violated resale limits, earning an estimated total of \$704,720 in excess profits (see figure). HUD requires that nonprofits use their excess profits to pay down the mortgages of the homebuyers they overcharged, but the agency's ability to enforce this requirement is extremely limited. As of July 2003, nonprofits had made only \$62,000 in payments on mortgages.

Resale Price Violations on Discounted Properties Sold in Calendar Year 2002

Home-ownership center	Nonprofits with resale price violations out of all that reported	Properties with resale price violations out of all properties reviewed	Total estimated excess profits
Atlanta	9 / 12	27 / 58	\$123,059
Denver	4 / 9	45 / 77	\$253,926
Philadelphia	3 / 6	18 / 37	\$186,942
Santa Ana	12 / 17	34 / 93	\$140,793
Total	28 / 44	124 / 265	\$704,720

Denotes number of nonprofits or properties with violations out of total.

Source: HUD.

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Abbreviations

FHA	Federal Housing Administration
GAO	General Accounting Office
HOC	homeownership center
HUD	Department of Housing and Urban Development
SAMS	Single-Family Acquired Asset Management System

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

January 30, 2004

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

Dear Mr. Chairman:

Each year, the Department of Housing and Urban Development (HUD) acquires tens of thousands of single-family properties through foreclosures when homeowners default on mortgages insured by the Federal Housing Administration (FHA). HUD sells these properties in as-is condition through its regular sales process and a number of smaller, specialized programs, including the Discount Sales Program. Under the Discount Sales Program, HUD sells properties at 10, 15, or 30 percent discounts to nonprofit organizations¹ and government entities² (nonprofits) that then rehabilitate (rehab) the homes as necessary and resell them to low- and moderate-income homebuyers. However, a November 2001 report by HUD's Inspector General concluded that low- and moderate-income homebuyers did not benefit significantly from the program; that many participating nonprofits were actually profit-motivated entities; and that HUD lacked effective approval, monitoring, and enforcement procedures.³ In light of these problems, the Inspector General recommended, among other things, that the agency suspend the program and evaluate the program's viability. Although HUD acted on many of the report's recommendations, it neither suspended nor evaluated the program.

¹HUD requires these organizations to have 501(c)(3) status. Section 501(c)(3) of the Internal Revenue Code covers charitable organizations that are eligible to receive tax-deductible contributions. Such organizations must not be organized or operated for the benefit of private interests, and no part of their net earnings may benefit any private shareholder or individual.

²Government entities include states, counties, cities, or other units of government such as public housing authorities. For purposes of this report, the term "nonprofit" includes nonprofit organizations and government entities.

³U.S. Department of Housing and Urban Development, Office of Inspector General, *Nonprofit Participation in HUD Single-Family Programs*, 2002-SF-0001 (Washington, D.C.: November 5, 2001). The audit covered the discounted properties HUD sold between January 1, 1998, and April 30, 2001.

As agreed with your office, this report assesses (1) the cost of the program to HUD, (2) the benefits of the program to homebuyers, and (3) HUD's efforts to monitor participating nonprofits and enforce program requirements. To address these objectives, we reviewed the program activities of HUD's Office of Housing and four homeownership centers (HOC) in Atlanta, Georgia; Denver, Colorado, Philadelphia, Pennsylvania; and Santa Ana, California. As agreed with your office, our work focused on the properties HUD sold through the program in calendar year 2002 and the monitoring and enforcement activities the HOCs performed in connection with those properties. To estimate the program's cost to HUD and its benefits to homebuyers, we performed a statistical analysis using data from HUD's Single-Family Acquired Asset Management System (SAMS)⁴ and the U.S. Census Bureau. We did not evaluate the extent to which the program generated other benefits, such as neighborhood revitalization. Appendixes II and III provide detailed information on our objectives, scope, and methodology.

Results in Brief

We estimate that the Discount Sales Program cost HUD between \$18.8 and \$23.9 million in calendar year 2002. Most of this cost, between \$15.1 and \$20.2 million, was a reduction in net revenue resulting from HUD's selling approximately 1,200 properties through the program rather than through its regular sales process, in which properties' prices are not discounted. The reduction in net revenue varied according to the discount level, with properties sold at a 30 percent discount accounting for the largest share of the total reductions. Personnel expenses for administering the program accounted for the remainder of HUD's cost. HUD estimates that its headquarters and HOCs allotted about 45 staff years⁵ to the program in calendar year 2002, primarily to oversee participating nonprofit organizations. According to HUD, these staff years equated to approximately \$3.7 million in personnel costs. HUD officials said that in the absence of the Discount Sales Program, these staff years would be allocated to other activities.

⁴SAMS contains information on the properties acquired and sold by HUD.

⁵We use the term "staff year" to mean the amount of time a full-time employee would work in the course of 1 year.

Our analysis of 238 homes sold under the Discount Sales Program in calendar 2002 indicates it is likely that most of the homebuyers did not benefit financially from the program.⁶ Specifically, assuming that nonprofits and homebuyers would incur the same costs to rehab a property, we estimate that 76 percent of the homebuyers would have spent less if they had purchased the properties through HUD's regular sales process and paid for the rehab work themselves. The estimated proportion of homebuyers who did not benefit varied by discount level, ranging from more than 90 percent at the 15 percent discount level to one-half at the 30 percent discount level. In part, homebuyers did not benefit because some nonprofits overcharged for some properties and some program rules authorize nonprofits to pass on costs—such as financing as closing costs—that homebuyers would likely not incur under HUD's regular sales process. We also found that while the program can provide access to a range of services and assistance that may benefit homebuyers, such as homeownership counseling, home maintenance courses, and down payment assistance, these services are also available from other sources. HUD has stated that the program generates benefits and supports policy goals, such as neighborhood revitalization and stability, that extend beyond benefits to individual homebuyers, but the agency has not studied the extent to which the program is serving these ends.

HUD's monitoring efforts have uncovered numerous program violations, but implementing the monitoring process and effectively enforcing program rules have been difficult. For example, one of the HOCs' primary monitoring tools is the desk review of the annual reports participating nonprofits are required to submit each February. However, as of July 2003 the centers had not received annual reports from nonprofits responsible for more than half of the 626 discounted properties that HUD estimates were purchased, rehabbed, and resold under the program during calendar year 2002. Further, as a condition of program participation, nonprofits must allow HUD staff to perform on-site reviews of their operations. However, the HOCs' use of these on-site reviews has been uneven. The Atlanta and Denver centers reviewed about half of their approved nonprofits in calendar year 2002, but the Philadelphia and Santa Ana centers reviewed few and none, respectively, citing limited staff resources and the difficulty of traveling to nonprofits' offices. But even with these limitations, the

⁶These were the only properties for which HUD could provide the rehab costs and selling prices to homebuyers as of July 2003. HUD estimates that 626 properties were purchased and resold under the program in calendar year 2002.

HOCs' desk and on-site reviews identified numerous violations of program requirements. For example, the centers' desk reviews found that nonprofits often did not comply with HUD limits on the resale price of discounted properties and earned excess profits from the program. Specifically, the reviews showed that 28 of the 44 nonprofits that submitted annual reports sold one or more properties at prices exceeding those allowed under the program, resulting in 124 homebuyers being overcharged an estimated total of \$704,720. However, the centers have had limited success enforcing the requirement that nonprofits making excess profits pay down the mortgages of homebuyers they overcharged. As of July 2003, nonprofits had used less than 10 percent of the estimated excess profits they made to pay down homebuyers' mortgages.

This report recommends that the Secretary of HUD (1) evaluate options to improve the program's benefit to homebuyers, the agency's monitoring of nonprofits, and enforcement of excess profits requirements; (2) assess the extent to which the program is meeting its objectives; and (3) terminate the program if its current cost plus the resources needed to improve it exceed the program's benefits. In comments on a draft of the report, HUD agreed with our recommendations to further assess the program but added that our analysis appeared to overstate the program's cost and understate its benefits.

Background

Established in 1993, HUD's Discount Sales Program seeks to expand affordable housing opportunities, help revitalize neighborhoods, and reduce the agency's inventory of single-family properties in a timely, efficient, and cost-effective manner.⁷ Under the program, approved nonprofit organizations receive a discount when purchasing HUD-owned single-family properties and are required to rehabilitate and resell them to low- or moderate-income homebuyers. As of August 2003, 423 nonprofits were approved to participate in the program, down from more than 2,000 nonprofits 3 years earlier. HUD attributed the reduction to changes in the program, such as stricter approval standards and increased reporting requirements, and to the agency's efforts to remove nonprofits that violate program rules.

⁷HUD has broad authority to dispose of single-family properties in its inventory. *See* 12 U.S.C. 1710(g).

HUD acquires properties through foreclosures of homes with FHA-insured mortgages. FHA provides federally backed mortgage insurance primarily to low-income and first-time homebuyers who might otherwise have difficulty obtaining a mortgage.⁸ In calendar year 2002, HUD acquired more than 67,000 properties through foreclosures and sold approximately 65,000 properties from its inventory. At the end of calendar year 2002, HUD had an inventory of 32,018 single-family properties.

HUD sells the properties in its inventory in as-is condition through a number of different programs. Table 1 shows the primary programs HUD uses to sell properties and the number of properties sold under each during calendar year 2002. Most HUD-owned properties are eligible for price reductions under the Discount Sales Program. The program accounted for approximately 2 percent of HUD's overall property sales in calendar year 2002.

Table 1: HUD's Calendar Year 2002 Single-Family Property Sales

Program	Number of properties
Regular sales	60,634
Officer Next Door ^a	1,168
Teacher Next Door ^a	925
Discount Sales	1,226
Asset Control Area ^b	795
Dollar Homes ^c	275
Total	65,023

^aThe Officer Next Door and Teacher Next Door programs offer HUD-owned properties at 50 percent discounts to law enforcement officers and teachers willing to live in economically distressed neighborhoods.

^bUnder the Asset Control Area program, participating nonprofits agree to purchase all of the HUD-owned properties located within specific geographic areas. The nonprofits receive discounts of up to 50 percent off HUD's list price.

^cThe Dollar Homes program allows local governments to purchase eligible HUD-owned properties for one dollar. The properties made available through the program are those HUD is unable to sell within 6 months.

⁸FHA insures most of its mortgages for single-family homes under its Mutual Mortgage Insurance Fund, which is funded by borrowers' insurance premiums and covers lenders' claims on foreclosed properties. The revenue HUD receives from selling these properties is deposited in the fund.

HUD offers discounts of 10, 15, and 30 percent to nonprofit organizations. The size of the discount depends on several factors: whether a property in as-is condition is eligible for FHA insurance, whether it is located in a revitalization area,⁹ and whether it is sold individually or in a package of five or more homes. HUD inspects and appraises all foreclosed properties to determine whether they are again eligible for FHA mortgage insurance. FHA will insure mortgages only on properties that meet HUD's minimum property standards and local building codes or that need less than \$5,000 in repairs in order to meet these standards. Properties needing more than \$5,000 in repairs are considered uninsurable. For purposes of the Discount Sales Program, HUD then differentiates properties by location. All insurable properties receive a 10 or 15 percent discount whether or not they are located in a revitalization zone. The 15 percent discount is only applied if the property is part of a group of five or more properties purchased in a single transaction. Uninsurable properties lying outside revitalization areas also receive these discounts, but those located within revitalization areas are eligible for the steepest discount—30 percent.

Under the Discount Sales Program, HUD has two methods of selling properties to nonprofits: competitive bidding and noncompetitive sales. Both methods allow discounts for nonprofits. Under the competitive process, HUD establishes a list price for the properties but will accept bids that are lower. HUD posts the properties, with their list prices, on the Internet in its general listings and accepts bids from prospective owner-occupants and nonprofits, but not investors, for a priority period of 10 to 30 days, depending on the geographic area. HUD awards the property to the owner-occupant or nonprofit with the highest bid. If the highest bidder is a nonprofit, HUD grants a 10 or 15 percent discount off the bid price when it closes on the home. For properties that fail to sell during this priority period, HUD then accepts bids from the general public, including investors.

The noncompetitive sales method applies only to uninsurable properties. HUD lists these properties separately from its general listings and makes them available to nonprofits through a HUD contractor's Web site. Nonprofits have a priority period of 5 days to express interest in the properties at HUD's list price. If more than one nonprofit expresses interest in a property, HUD selects the buyer by lottery. As with competitive sales, the discount is applied at closing. Properties that are not sold

⁹Revitalization areas are HUD-designated locations characterized by high levels of foreclosures, very low incomes, and low homeownership rates.

noncompetitively are placed in HUD's general listings and made available for sale on a competitive basis.

Nonprofits that purchase properties under the Discount Sales Program are responsible for rehabilitating them as needed to meet HUD's minimum property standards and local building codes. Nonprofits are required to limit their resale price to no more than 110 percent of their "net development cost," or the sum of their allowable costs for acquiring, rehabilitating, and reselling the properties. Nonprofits must also sell the homes to buyers whose incomes do not exceed 115 percent of their area's median income, adjusted for family size.

HUD's four HOCs administer the Discount Sales Program and oversee the participating nonprofits. The HOCs process nonprofits' applications to participate in the program and monitor nonprofits for compliance once they begin purchasing, rehabilitating, and reselling homes. To help monitor the program, HUD requires nonprofits to submit annual reports to the appropriate HOC by February 1 of each year. The reports must provide information on properties the nonprofits have bought, rehabilitated, and resold, including repair costs, prices to homebuyers, and homebuyers' incomes. HOC staff also conduct on-site visits to nonprofits and properties to review files and inspect repairs, among other things. When a nonprofit fails to follow the program's requirements, HOCs may remove the nonprofit from the program.

In recent years, HUD has changed some of its program requirements to increase its oversight of nonprofits. For example, in 2000 HUD issued guidance establishing uniform standards for nonprofits applying to participate in the program. The guidance outlines specific information nonprofits must submit in applying for the program, mandates that nonprofits recertify with HUD every 2 years, and requires that nonprofits answer detailed questions about their ability to carry out affordable housing programs.

To address concerns raised in the HUD Inspector General's 2001 report on the program, HUD issued additional guidance in December 2001 designed to strengthen the program's reporting and accountability requirements. Until this guidance was issued, nonprofits needed to meet HUD's annual reporting and net development cost requirements only for properties purchased at a 30 percent discount. The guidance expanded annual reporting and resale price requirements to all properties, regardless of

discount level, and clarified HUD's net development cost calculation by providing a detailed list of allowable and unallowable costs.

Also in response to the Inspector General's report, HUD issued guidance in January 2002 designed to tighten eligibility requirements for nonprofits. Among other things, the guidance described circumstances that could create a conflict of interest between nonprofits and their business partners. In addition, it required that nonprofits be incorporated as 501(c)(3) organizations for at least 2 years and have a minimum of 2 consecutive years of affordable housing experience within the last 5 years. Finally, to accommodate HUD's on-site reviews, the guidance required nonprofits to maintain property records in a specified format.

HUD did not implement all of the Inspector General's recommendations. Specifically, the Inspector General's report recommended that HUD suspend the program and evaluate it to determine whether the program was viable or should be discontinued. HUD Office of Housing officials told us they developed a proposal for a contractor study of the program but that the proposal was never funded. HUD officials said they did not suspend the program because they felt the improvements made following the Inspector General's review would prevent further problems.

In 2002, the Discount Sales Program Cost HUD at Least \$18.8 Million

We estimate that the Discount Sales Program cost HUD between \$18.8 and \$23.9 million in calendar year 2002. Most of this cost, between \$15.1 and \$20.2 million, was a reduction in net revenue resulting from HUD's selling properties through the program rather than through its regular sales process.¹⁰ Personnel expenses for administering the program accounted for the remaining \$3.7 million of HUD's cost.

¹⁰We defined net revenue as the price for which HUD sells a property minus HUD's holding and selling costs. These costs include discounts to nonprofits, other homebuyer sales incentives, payments to management and marketing contractors, property taxes, broker's fees and commissions, and financing and closing costs. HUD was not able to provide us with property-specific data on certain overhead expenses that it allocates among the properties in its inventory. As a result, we did not include these expenses in our analysis. Because these expenses are relatively small, we believe this omission did not have a significant effect on our estimates.

The Discount Sales Program Reduced HUD's Net Revenue

The net revenue HUD receives from each property it sells is less than the property's selling price because HUD incurs certain holding and selling costs. Some of these costs are common to both discounted and regular HUD property sales, while others are not. For example, on a regular sale, HUD pays the homebuyer's closing and financing costs and the sales commission of the successful selling broker, within certain guidelines. HUD does not pay either of these costs for properties sold through the Discount Sales Program. HUD does not require a selling broker for the properties nonprofits purchase through the program; consequently, there is generally no selling broker's commission for these transactions. HUD incurs other types of costs for all properties whether or not they are part of the program. These costs include (1) the fees and reimbursable expenses it pays to management and marketing contractors responsible for inspecting, appraising, securing, maintaining, and selling HUD-owned properties; (2) sales incentives in the form of cash allowances that HUD periodically offers to homebuyers—including nonprofits—that close relatively quickly on executed sales contracts; (3) the listing broker's fee; and (4) the property taxes for the period when HUD owned the home.

To determine the impact of the Discount Sales Program on HUD's net revenues (i.e., the selling price minus holding and selling costs) we compared the estimated net revenues HUD received for the discounted properties with the estimated net revenues HUD would have received if it had sold the properties through its regular sales process.¹¹ Using data from HUD's SAMS and the U.S. Census Bureau, we made this determination for

¹¹We derived our estimates from a model we developed that predicts the net revenue HUD received from each property it sold during calendar year 2002 as a function of several variables, including whether HUD sold the house through the Discount Sales Program. The model allowed us to estimate the effect of the program on HUD's net revenue, while holding constant the effects of other factors. We made this estimate by comparing (1) the net revenue our model predicted HUD would have received for each discounted property had the property been sold through the regular sales process with (2) the net revenue our model predicted HUD would have received by selling the property through the Discount Sales Program. Even though we knew the actual amount HUD received by selling the property through the Discount Sales Program, we made the comparison between two estimated values in order to be consistent. Each estimated value contained an error term that captured the effects of omitted variables unavailable for the modeling process. By comparing two estimated values, we removed the influence of the omitted variables from our comparison, leaving the effect of the Discount Sale Program. Appendix II provides additional information about our model.

1,194¹² properties that HUD sold through the program in calendar year 2002. We used a statistical model that included data for these properties and approximately 4,000¹³ properties HUD sold through its regular process during the same year.¹⁴ We found that by selling the 1,194 properties through the Discount Sales Program instead of its regular sales process, HUD reduced the net revenue it received in calendar year 2002. Specifically, we estimate that the total reduction in HUD's net revenue was between \$15.1 and \$20.2 million,¹⁵ an average of between \$12,672 and \$16,945 per property. (See app. II for a detailed discussion of our statistical analysis.) Without the program, and with all other things remaining equal, cash flows into HUD's insurance fund would have increased by that amount.

As shown in table 2, the overall and average reductions in net revenue varied according to the discount level. The properties sold with 10 percent discounts accounted for about two-thirds of the homes that HUD sold through the program in calendar year 2002, but for less than half the total estimated reduction in net revenue. In contrast, the properties sold with 30 percent discounts represented less than one-third of the total properties sold but more than 40 percent of the overall reduction in net revenue. Finally, the properties with 15 percent discounts accounted for about 9 percent of the total properties and between 7 and 10 percent of the overall reduction in HUD's net revenue.

According to HUD officials, the agency's database somewhat overstates the number of properties sold with a 10 percent discount (the most common type) and somewhat understates the number sold with a 15 percent discount (the least common type). The officials said this overstatement occurs because HUD does not always update its database to reflect the fact

¹²HUD sold a total of 1,226 properties through the Discount Sales Program in calendar year 2002. Because we were unable to match 32 of the properties to census tract data, we dropped them from our analysis, leaving 1,194 properties.

¹³These were all of the homes HUD sold through its regular process that were located in the same census tracts as the properties it sold through the Discount Sales Program.

¹⁴Our analysis assumed that in the absence of the program, HUD would have sold the 1,194 properties through its regular sales process. Accordingly, our statistical analysis excluded data on properties that were not sold through either the Discount Sales Program or HUD's regular process.

¹⁵We are 90 percent confident that HUD's actual loss in net revenue was between these two values.

that a property, indicated in the database as being sold with a 10 percent discount, may actually have been sold at a 15 percent discount if it was part of a group of five or more properties bought in a single transaction. As a result, our analysis may overestimate the reduction in net revenue for properties discounted by 10 percent and underestimate it for those discounted by 15 percent.

Table 2: Estimated Reduction in Net Revenue Due to the Discount Sales Program in Calendar Year 2002, by Discount Level

Discount level	Number of properties sold	Total estimated reduction in net revenues (dollars in millions)	Average estimated reduction in net revenues per property
10 percent	744	\$6.6 – \$9.3	\$8,844 – \$12,453
15 percent	102	1.0 – 1.9	10,223 – 18,997
30 percent	348	7.5 – 9.0	21,572 – 25,947
Total	1,194	\$15.1 – \$20.2	\$12,672 – \$16,945

Sources: HUD and the U.S. Census Bureau.

Note: Our confidence level for the estimates is 90 percent.

As shown in table 3, the overall and average reductions in net revenues also varied by HOC. A major reason for this variance was differences among the centers in the proportion of their properties sold with 30 percent discounts. Because 30 percent discount properties cost HUD more in net revenue than properties at the other discount levels, the HOC with the highest proportion of 30 percent properties—Santa Ana—had the greatest reduction in net revenue. The HOC with the lowest proportion—Denver—had the smallest reduction in net revenue.

Table 3: Estimated Reduction in Net Revenue Due to the Discount Sales Program in Calendar Year 2002, by Homeownership Center

Homeownership center	Number of properties sold	Total estimated reduction in net revenues (dollars in millions)	Average estimated reduction in net revenues per property
Atlanta	296	\$2.8 – \$3.8	\$9,317– \$12,744
Denver	183	1.2 – 2.3	6,551 – 12,689
Philadelphia	359	3.5 – 4.7	9,712 – 13,061
Santa Ana	356	7.7 – 9.4	21,592 – 26,542
Total	1,194	\$15.1 – \$20.2	\$12,672 – \$16,945

Sources: HUD and the U.S. Census Bureau.

Note: The estimates may not add up to totals due to rounding. Our confidence level for the estimates is 90 percent.

HUD officials told us they were aware that the program reduced the agency’s net revenue from property sales. However, HUD has not evaluated whether the program is reducing HUD’s property inventory in a timely, efficient, and cost-effective manner, as intended.

HUD Incurred Administrative Costs Operating the Discount Sales Program

To determine the impact of the Discount Sales Program on HUD’s administrative costs in calendar year 2002, we compared the administrative costs HUD incurred under the program to what HUD would have incurred had the discounted properties been sold through HUD’s regular process. According to HUD, in administering the Discount Sales Program, HOC staff perform tasks that are not part of HUD’s regular home-selling process. For example, for the Discount Sales Program, center staff approve and recertify participating nonprofit organizations and monitor the nonprofits’ compliance with program requirements—tasks they do not perform for the regular sales process. As a result, HUD’s administrative cost per property is lower for its regular sales process than it is for the Discount Sales Program. HUD officials told us that for this reason and the small volume of properties sold through the Discount Sales Program, selling the discounted properties through HUD’s regular process would have had no measurable effect on the administrative costs for the regular sales process.

The bulk of HUD’s administrative costs for the Discount Sales Program are the salaries and benefits of staff who work on the program. According to HUD officials, most of these staff split their time among several programs,

but HUD's time and attendance system does not record the time they spend on each one. Therefore, we relied on estimates from HUD to determine how many staff years were spent on the program in calendar year 2002 and the associated costs. Although HUD incurred other types of costs to administer the program, such as mailing costs and travel expenses for visiting nonprofit offices, these were minor compared with the personnel costs and were not included in HUD's estimate.

HUD estimates that its personnel costs for the Discount Sales Program were approximately \$3.7 million in calendar year 2002.¹⁶ (See table 4.) HUD's estimate was based on information provided by its HOCs and Office of Housing, which showed that their staffs devoted a total of 45 staff years to the program. The number of staff years and the associated cost varied across offices, however. Among the HOCs, the Atlanta center had the most staff years and highest personnel costs and the Denver center the fewest staff years and lowest personnel costs. HUD's Office of Housing devoted the equivalent of about one staff year to the program. HUD headquarters and HOC officials told us that in the absence of the Discount Sales Program, these staff years would have been dedicated to administering other HUD programs, so that HUD would have incurred the personnel costs with or without the program.

Table 4: HUD's Estimate of Personnel Costs for the Discount Sales Program in Calendar Year 2002, by Homeownership Center

	Atlanta center	Denver center	Philadelphia center	Santa Ana center	HUD headquarters	Total
Staff years	17.0	5.2	11.8	10.4	0.8	45.1
Personnel costs	\$1,386,740	\$423,930	\$957,919	\$844,599	\$75,263	\$3,688,451

Source: HUD.

¹⁶HUD officials stressed that the estimate of personnel costs was only a rough approximation of the agency's actual costs.

The Discount Sales Program Is Not Likely to Benefit Most Homebuyers Financially but Can Help Them Access Homeownership Services and Assistance

Our analysis of 238 properties sold under the Discount Sales Program in calendar year 2002 indicates it is likely that most homebuyers did not benefit financially from the program. Specifically, assuming that nonprofits and homebuyers had the same rehab costs, we estimate that 76 percent of the homebuyers would have spent less if they had purchased the properties through HUD's regular sales process and paid for the rehab work themselves. In part, the lack of financial benefit to homebuyers is attributable to the program's rules, which authorize nonprofits to pass on costs that homebuyers would likely not incur using the regular sales process. Despite the program's limited financial benefits, it may help homebuyers access a range of services and assistance—such as homeownership counseling, down payment assistance, and home maintenance courses—that are beneficial but also available from other sources. The program may also help improve neighborhood conditions by rehabbing and putting back on the market homes that might otherwise remain vacant or in disrepair.

The Financial Benefit of the Program to Most Homebuyers is Doubtful

To determine the extent to which homebuyers benefited financially from purchasing a rehabilitated home through the Discount Sales Program, we performed a statistical analysis comparing what the homebuyers actually paid for these homes with our estimate of what they would have spent had they purchased the homes under HUD's regular process and paid for the rehab work themselves. Our analysis assumed that in the absence of the Discount Sales Program, a homebuyer would be able to (1) purchase the same home and rehabilitate it to the same extent as the nonprofit and (2) incur the same rehab costs as the nonprofit.¹⁷ We also assumed that the homebuyer would inhabit the home during the rehabilitation and therefore would not incur housing expenses for two residences during that period.¹⁸ We performed this analysis on 238 properties that nonprofits purchased

¹⁷HUD does not collect the data necessary to test this assumption. In addition, the data HUD provided us on nonprofits' rehab costs did not always include other, relatively minor, expenses that an individual homebuyer could also incur, such as fees for rehab consultants, construction permits, and termite inspection services. However, as discussed later in this section, our overall finding does not change even under the assumption that a homebuyer would pay significantly more than a nonprofit to rehab a home.

¹⁸While this assumption would not hold true in all cases, more than half of the properties covered by our analysis received less than \$15,000 in rehab work and some received none at all, suggesting that the rehab work was generally not so extensive as to require vacating the home.

and resold between February 1 and December 31, 2002.¹⁹ These properties were the only ones for which HUD could provide the rehab costs and selling prices to homebuyers at the time of our review. (See app. II for a detailed discussion of our statistical analysis.)

Assuming equal rehab costs for nonprofits and homebuyers, we estimate that 182 of the 238 homebuyers, or 76 percent, did not benefit financially by purchasing a rehabbed property from a nonprofit that bought the property through the Discount Sales Program. That is, the buyers would have spent less had they purchased the property through HUD's regular sales process and paid for the rehab work themselves. Under the assumptions of our analysis, we estimate that these purchasers spent an average of \$9,200 more buying the house through the program than they would have spent otherwise. Our analysis indicated that the other 24 percent of the homebuyers benefited financially from the program, because purchasing the homes through HUD's regular sales process and rehabbing them would have been more expensive. We estimate that these homebuyers saved \$9,200, on average, by purchasing through the Discount Sales Program. Because nonprofits may, in some circumstances, be able to rehab a home more cheaply than an individual homebuyer, we also performed the analysis assuming that a homebuyer would pay 25 percent more than a nonprofit for the same rehab work. Even under that assumption, we estimate that 59 percent of the homebuyers would not have benefited financially from the program. More specifically, we estimate these purchasers spent an average of \$8,000 more buying the house through the program than they would have spent otherwise. We estimate that the remaining 41 percent of homebuyers saved \$10,100, on average, by purchasing a home through the program.

Our estimates of the extent to which homebuyers did or did not benefit varied according to the discount level of the property purchased. Assuming equal rehab costs for nonprofits and homebuyers, we estimate that 79 percent of the homebuyers purchasing houses that had been discounted 10 percent saw no financial benefit. For the properties with 15 percent discounts, we estimate that more than 90 percent did not benefit. However, for the properties with 30 percent discounts, we estimate that one-half of the homebuyers saw some financial benefit. (See table 5.)

¹⁹We used this time frame because HUD made significant changes to the program that became effective on February 1, 2002. For example, HUD expanded its annual reporting and resale price requirements to properties sold with 10 and 15 percent discounts.

One reason homebuyers did not benefit financially, according to our analysis, was that nonprofits sometimes resold the properties for more than the program allowed.²⁰ This finding was especially strong for purchases in the 15 and 30 percent discount categories. Had the nonprofits not overcharged the homebuyers in these cases, we estimate that more than one-third of the homebuyers who bought properties with a 15 percent discount and more than three-quarters of those who bought properties with a 30 percent discount would have benefited financially.

Table 5: Estimated Number of Homebuyers Who Did and Did Not Benefit Financially by Purchasing Homes through HUD’s Discount Sales Program

Discount level	Number of properties	Number of homebuyers who benefited financially	Number of homebuyers who did not benefit financially
10 percent	143	30	113
15 percent	51	4	47
30 percent	44	22	22
Total	238	56	182

Sources: HUD and the U.S. Census Bureau.

Our analysis did not take into account certain factors that are difficult to quantify but may make the program either more or less beneficial from a homebuyer’s perspective. For example, some homebuyers may be willing to incur significant costs to avoid the time, difficulty, and inconvenience involved in selecting materials, obtaining and evaluating contractor bids, residing in a property undergoing rehab work, and possibly obtaining a separate loan to finance the rehab work.²¹ Conversely, some homebuyers may not view these tasks as major obstacles and may see significant benefits to controlling the rehab process themselves, such as the ability to select the materials used and the ability to oversee the rehab work as it progresses.

²⁰The issue of nonprofits violating resale price restrictions is discussed in more detail in the next section of the report.

²¹Although a homeowner would incur fees and interest costs for such a loan, homebuyers financing properties purchased through the Discount Sales Program incur similar expenses because the cost of the rehab work is included in the nonprofit’s selling price and therefore is reflected in the homebuyer’s mortgage costs.

The Discount Sales Program's Rules Reduce the Likelihood That Buyers Will Benefit Financially

Some of the Discount Sales Program's rules make it unlikely that purchasing a property from a nonprofit that purchased the property from HUD at a 10 or 15 percent discount will benefit homebuyers more than purchasing the same property from HUD through the regular sales process. For example, HUD allows nonprofits to resell discounted properties for up to 110 percent of the "net development cost," or the cost of buying the property plus allowable rehab, holding, and selling costs. The 10 percent markup helps nonprofits to cover the overhead expenses they incur by participating in the program. However, taking a 10 percent markup on a property purchased at a 10 or 15 percent discount effectively cancels out all or most of the discount. As a result, the price of the home to the eventual homebuyer reflects little, if any, of HUD's discount to the nonprofit.

Furthermore, program rules authorize nonprofits to include in their calculations of net development cost certain "allowable" financing and closing costs they incur in buying discounted HUD properties. As a result, a homebuyer who purchases a property from a nonprofit pays not only his or her own financing and closing costs but—through the sales price—the nonprofit's as well. In contrast, when a homebuyer purchases a property using HUD's regular sales process, HUD pays allowable financing and closing costs on the buyer's behalf. Also, a nonprofit's net development cost may include the principal and interest payments for the mortgage on the property while the property is being renovated for up to 6 months. Raising the nonprofit's net development cost effectively raises the price for the eventual homebuyer, who could have avoided some of these expenses by purchasing the house directly from HUD and, if possible, inhabiting it during the renovation.

The Discount Sales Program May Help Homebuyers Access Certain Services and Assistance and Improve Neighborhood Conditions

According to HUD and nonprofit officials, many of the families who purchase properties through the program are first-time homebuyers. Accordingly, HUD strongly encourages nonprofits to provide homeownership counseling services and requires participants to submit "affordable housing plans" detailing, among other things, the services and assistance that low- and moderate-income homebuyers using the program can expect to receive. During our visits to HUD's homeownership centers, we reviewed the affordable housing plans for a judgmental sample of 17 nonprofits. The plans showed that the nonprofits offered a wide range of services and assistance to homebuyers, either directly or through referrals to other agencies. The services included mortgage credit counseling, "hotlines" homebuyers could call with questions, and courses on budgeting

and home maintenance. Some nonprofits also offered assistance with down payments and closing costs. HOC staff told us that these services and assistance were typical of those provided by most participating nonprofits.

Both HUD and nonprofit officials told us they believed that providing such services to new homebuyers facilitated homeownership among low-income families that might otherwise have a hard time purchasing a home. These officials also said that the services helped minimize the likelihood of default by preparing families for the responsibilities of homeownership. However, we found that similar services were widely available outside the Discount Sales Program. For example, HUD itself provides financial support to hundreds of housing counseling agencies across the country. Any prospective homebuyer can access these services at no cost.

According to HUD, the Discount Sales Program also generates benefits and serves policy objectives, such as neighborhood revitalization and stability, that extend beyond the individual households that purchase properties. Some HUD and nonprofit officials told us they believe that the Discount Sales Program may help to improve neighborhood conditions by supporting the rehabilitation and sale of properties that would otherwise be vacant and in disrepair, reducing surrounding property values, and becoming magnets for vandalism and trespassing. For example, one nonprofit official told us that by purchasing and rehabbing multiple properties over a period of several years, the organization had not only improved the housing stock of one community but also helped create an environment that encouraged economic development and social service opportunities nearby. HUD officials also told us that many prospective owner-occupants are not willing to purchase homes requiring significant rehab work because of the difficulty and risks of undertaking a rehab project. They said that even if owner-occupants were to purchase these properties, they might do less rehab work than a nonprofit would or not rehab them at all. Finally, HUD believes that by promoting homeownership and property rehabilitation, the program has stabilizing effects on neighborhoods and contributes to property values—factors that reduce the risk of foreclosure and losses to FHA's insurance fund. Although expansion of homeownership opportunities and neighborhood revitalization are objectives and potential benefits of the program, HUD has not studied the extent to which the program is serving these ends.

Limited Monitoring Efforts Have Uncovered Numerous Violations, but Effective Enforcement Has Been Difficult

The HOCs use two monitoring tools to assess nonprofits' compliance with program requirements: desk reviews of annual reports and on-site evaluations. However, the HOCs had trouble conducting desk reviews because many program participants turned their reports in late or not at all, and many reports were incomplete. In addition, the HOCs' use of on-site reviews was uneven, with two centers conducting them routinely and the other two doing few or none. Even with these problems, the HOCs' monitoring efforts uncovered numerous violations of program rules, such as making excess profits by reselling discounted properties for more than the program allowed. The HOCs have removed many nonprofits for noncompliance but lack an effective mechanism for enforcing requirements concerning excess profits.

Effectiveness of Desk Reviews is Hampered by Missing or Incomplete Information

Nonprofits participating in the Discount Sales Program are required to submit annual reports to the HOCs each February 1 that provide information on the properties purchased under the program the previous calendar year.²² The required information includes the status of the property (i.e., whether it has been rehabbed and resold), the rehab costs, and the selling price to the homebuyer. Nonprofits must also provide documentation, such as settlement statements, giving detailed financial information on the purchase and resale of the properties.

Desk reviews of these reports are HUD's primary method of determining whether nonprofits comply with key program requirements, such as those restricting the resale prices of rehabilitated homes and the purchasers' income levels. However, the effectiveness of desk reviews as a monitoring tool has been limited because many nonprofits have not submitted annual reports on time, and others have provided incomplete information. Specifically, as of July 2003—more than 5 months after the annual reports were due—HUD lacked reports from nonprofits accounting for more than half of the 626 properties it estimates were bought, rehabbed, and resold in calendar year 2002. The HOCs had reports for properties resold to homebuyers from only 44 of the 166 nonprofits that purchased discounted properties in calendar year 2002. Other nonprofits submitted reports that lacked all of the data the HOCs needed to assess the participants'

²²HUD has required annual reports on properties sold at a 30 percent discount since December 1994. Beginning with reports due in February 2003, HUD expanded the requirement to include all properties sold at a discount.

compliance with program requirements. For example, as of April 2003, more than half of the annual reports received at the Denver HOC did not contain the information necessary to determine the nonprofits' net development costs for the properties. As a result, staff could not determine whether the nonprofits had sold their properties at prices that were within program limits. Similarly, more than one-third of the reports received by the Atlanta HOC as of July 2003 did not contain the required certification of the homebuyers' income levels. Without this information, the HOC had no assurance that the properties were sold to homebuyers with low and moderate incomes, as required.

According to HOC officials, efforts to collect missing data and resolve other reporting issues can take months. For example, staff at the Atlanta HOC told us that they spent large amounts of time calling and writing nonprofits to gather the information missing from the annual reports. Although three of the HOCs—Atlanta, Denver, and Santa Ana—had originally planned to complete their desk reviews by the end of April 2003, these reviews were still under way in mid-July 2003. At that time, the remaining HOC—Philadelphia—had completed reviews of just 16 percent of its properties.

The reporting problems occurred despite the HOCs' efforts to remind nonprofits of the reporting requirements and to provide training on the program rules. For example, all four HOCs sent reminder letters to nonprofits several weeks before the annual reports were due. In addition, HOC officials told us they provided either one-on-one or group training to nonprofits on submitting annual reports and meeting other program requirements. HOC officials speculated that a major reason for the reporting problems was that many nonprofits lacked adequate administrative capacity. However, they also said that carrying out in-depth assessments of administrative capacity as part of the initial approval process would require a costly on-site evaluation of every applicant.

In October 2003, HOC officials told us that as a result of their follow-up efforts, they had made significant progress in obtaining annual reports from nonprofits that had not reported earlier in the year. However, during the long time it takes the HOCs to obtain and review annual reports, nonprofits may continue to purchase more homes and violate program rules. In addition, according to HOC officials, many nonprofits that had failed to report had either withdrawn or been removed from the program, leaving little incentive to report. Consequently, it is unlikely that HUD will

ever know whether these nonprofits followed program requirements in rehabbing and reselling discounted properties.

The Number of On-Site Reviews Varied Across Homeownership Centers

HUD's guidelines not only require that nonprofits allow on-site reviews of their operations as a condition of program participation but also outline the types of records participants must maintain and make available for HUD's on-site review. On-site reviews generally allow for a more in-depth assessment of a nonprofit's program activities than desk reviews. For example, on-site reviews may include examining invoices and cancelled checks to determine the validity of claimed rehab costs. They may also involve inspection of rehabbed homes and interviews with homeowners.

We found that only two of the four HOCs—Atlanta and Denver—routinely used on-site reviews as a monitoring tool in calendar year 2002. Atlanta HOC officials told us that they tried to review each of their medium- and high-risk nonprofits at least once every 2 years.²³ Consistent with this policy, the center performed 22 on-site reviews in calendar year 2002, covering about half of the nonprofits that had purchased discounted homes that year. The Atlanta HOC had trained staff stationed throughout the center's geographic jurisdiction to perform the on-site reviews and also employed two specialists with backgrounds in home construction. The Denver HOC performed on-site reviews of 10 of the 23 nonprofits it sold properties to in calendar year 2002. Officials there said that they targeted nonprofits using desk reviews, homebuyers' complaints, and applications to the program. The reviews were performed by staff working out of the HOC, with assistance from other HUD staff stationed near the nonprofits.

In contrast to the Atlanta and Denver centers, the other two HOCs—Philadelphia and Santa Ana—used on-site reviews rarely or not at all. The Philadelphia HOC, which sold properties to 48 nonprofits in calendar year 2002, conducted just two on-site reviews during that year, citing a shortage of staff as the primary reason. Center officials told us that they plan to use a contractor to conduct on-site reviews of nonprofits with known performance problems and that the contractor will be required to have construction specialists assist in these reviews. The Santa Ana HOC, which sold properties to 52 nonprofits in calendar year 2002, did not perform any on-site reviews. Santa Ana HOC officials told us that the center's large

²³The Atlanta HOC designates nonprofits that purchase five or more properties in a year as medium- or high-risk.

geographic jurisdiction made it impractical for them to travel to nonprofits' offices. To compensate for the lack of on-site reviews, the Santa Ana center uses an in-depth version of the desk review, requiring nonprofits to submit large amounts of supporting documentation, including invoices, with their annual reports. A Santa Ana official said that this is the same documentation that HOC staff examine during on-site reviews but acknowledged that desk reviews do not include property inspections.

Despite Monitoring Limitations, HOCs Uncovered Numerous Program Violations

The HOCs identified violations of program requirements during both desk and on-site reviews. Primary among these were violations of the ceiling for resale prices: 110 percent of the net development cost.²⁴ The desk reviews the HOCs had conducted as of July 2003 showed that nonprofits often did not comply with the resale restriction. This problem occurred despite the fact that in December 2001 HUD had issued guidance to nonprofits clarifying net development costs and providing detailed instructions for calculating them.

As shown in figure 1, 28 of the 44 nonprofits that had submitted annual reports as of July 2003 overcharged homebuyers for one or more properties. These violations occurred on about 124 (47 percent) of the 265 properties covered by the annual reports and resulted in homebuyers being overcharged an estimated total of \$704,720.²⁵ The amount of the estimated overcharges varied significantly from property to property, ranging from under \$10 to more than \$40,000. For example, one nonprofit closed on a discounted home in New York for \$117,600 in October 2002 and spent about \$41,000 to rehab the property. The nonprofit subsequently resold the property for \$234,000, or \$43,333 more than the program allowed. Assuming the homebuyer had secured a 30-year loan at 6 percent interest (the prevailing rate at the time the homebuyer made the purchase), the overcharge increased the homebuyer's annual mortgage payments by more than \$3,100.

²⁴In purchasing a discounted property, a nonprofit must sign an addendum to the sales contract stating that it will adhere to this rule.

²⁵This figure is an estimate because as of July 2003 the HOCs had not made final determinations of excess profits for all of the properties they had reviewed. As a result, the actual amount of excess profits for these properties may be higher or lower than this amount.

Figure 1: Resale Price Violations Disclosed by Desk Reviews of Nonprofits' Annual Reports on Calendar Year 2002 Program Activity

Home-ownership center	Nonprofits with resale price violations out of all that reported	Properties with resale price violations out of all properties reviewed	Total estimated excess profits
Atlanta	9 / 12	27 / 58	\$123,059
Denver	4 / 9	45 / 77	\$253,926
Philadelphia	3 / 6	18 / 37	\$186,942
Santa Ana	12 / 17	34 / 93	\$140,793
Total	28 / 44	124 / 265	\$704,720

Denotes number of nonprofits or properties with violations out of total.

Source: HUD.

The HOCs' desk reviews also identified three cases in which nonprofits violated program requirements by reselling discounted properties to homebuyers whose incomes exceeded 115 percent of the area median income. For example, the Denver HOC found that one of its nonprofits sold a Texas home to a buyer whose income was 141 percent of the area median income, adjusted for family size.

The HOCs' on-site reviews also revealed instances of serious noncompliance, underscoring the importance of these reviews as a monitoring tool. Among these violations were a lack of auditable records, unallowable rehabilitation costs, and conflicts of interest between nonprofits and their rehabilitation contractors. For example, one review disclosed that the nonprofit had made bulk purchases of the materials it needed to rehabilitate discounted properties but, contrary to program requirements, did not maintain records showing the costs of these purchases or the materials that were used for each home. As a result, the reviewers could not verify the net development cost for any of these properties. In another on-site review, the Atlanta staff found that the nonprofit was not in control of the day-to-day operations of its discount property purchases. Instead, the nonprofit allowed its affiliated contractors and realtors to control the buying, rehabbing, and selling of the properties

acquired through the Discount Sales Program and to share in the profits from the sale.

HOCs Have Removed Violators from the Program but Lack Effective Means to Enforce Requirements on Excess Profits

To hold nonprofits accountable for program violations, the HOCs may use two main enforcement tools: (1) removing participants from the program and (2) requiring them to use excess profits to pay down overcharged homebuyers' mortgages. The HOCs have often exercised their authority to remove nonprofits but lack an effective mechanism for enforcing requirements concerning excess profits. As a result, some nonprofits that did not comply with program requirements have retained excess profits, and homebuyers who were overcharged have not received financial restitution.

HOCs Frequently Removed Nonprofits from the Program, but the Process Has Limitations

HUD issued regulations in June 2002 authorizing the agency to remove a nonprofit from its roster of approved organizations for any cause HUD judged to be detrimental to the agency or to any of its programs.²⁶ These causes include failure to comply with HUD guidance and instructions and failure to respond within a reasonable time to HUD inquiries, including requests for documentation. In recent years, the HOCs frequently used removal to hold nonprofits in the Discount Sales Program responsible for a variety of compliance problems. In calendar year 2002, for example, the Santa Ana HOC removed 31 nonprofits from the program, mostly for failure to submit annual reports, conflicts of interest, selling homes for more than program limits or to families that were not low- or moderate-income, and lack of administrative or financial capacity. In calendar year 2003, all four HOCs removed nonprofits that had failed to file annual reports or committed other program violations. For example, as of October 2003, the Atlanta HOC had removed 18 nonprofits from the program—more than one-third of the nonprofits that had purchased discounted properties in calendar year 2002. The other three HOCs removed a total of 63 nonprofits that had purchased properties that year.

Despite its importance as an enforcement tool, HOC officials told us that removing nonprofits from the program had significant limitations. First, the process can take months to complete, allowing nonprofits to continue purchasing properties and possibly to commit additional violations. HOC

²⁶Prior to that time, HUD did not have regulatory procedures for taking this action and removed nonprofits through a less formal process.

staff must carefully document their justification for the action and must follow due process procedures that can be lengthy, particularly if a nonprofit appeals the removal decision. HOC officials said that once they decide to remove a nonprofit, they often restrict the number of properties it may purchase in an effort to reduce the potential for further noncompliance during the due process period. Second, once a nonprofit is removed, it has little incentive to report to HUD on the discounted properties it resold or to surrender any of the excess profits it may have earned. As a result, the centers may never learn whether these properties were resold at reasonable prices to low- or moderate-income homebuyers, and the homebuyers who were overcharged for their properties do not receive any financial restitution.

HOCs Had Limited Success Recovering Excess Profits

In December 2001, HUD issued instructions requiring nonprofits to sign an addendum to every sales contract that limited the resale price of discounted homes to 110 percent of the net development cost. The instructions also mandated that nonprofits use the excess profits they earn by exceeding the 110 percent limit to pay down the mortgages of the homebuyers they overcharged.

The four HOCs have attempted to implement this requirement by requesting mortgage “pay downs” from nonprofits that are making excess profits. However, Philadelphia HOC officials and attorneys from HUD’s Office of General Counsel also told us that the agency’s authority to enforce the requirement was not specified in regulation and was therefore in question. Furthermore, the attorneys said that as a practical matter the requirement would be difficult to enforce, as HUD would have to refer nonprofits that refused to comply to the Department of Justice for legal action. The officials said they doubted whether Justice would accept these cases because the amounts of money involved are generally relatively small—often less than \$10,000—and it would be cost-prohibitive for Justice’s attorneys to pursue them. HUD officials added that obtaining enough documentation to build a convincing legal case was difficult, because many nonprofits do not keep proper financial records that adequately document the amount of excess profits earned.

As a result of these problems, the HOCs had limited success getting nonprofits to use excess profits to pay down homebuyers’ mortgages. According to HOC officials, the nonprofits that have paid down mortgages did so voluntarily because they wanted to stay in the program. As of July 2003, the HOCs’ desk reviews had identified 28 nonprofits that made an estimated total of \$704,720 in excess profits. At that time, seven of the

nonprofits had made combined mortgage pay downs of \$62,002, or only about 9 percent of the total estimated excess profits. (See table 6.)

Table 6: Percentage of Estimated Excess Profits Used to Pay Down Homebuyer Mortgages, as of July 2003

Homeownership center	Number of properties resold for more than program limits	Estimated excess profits	Amount of estimated excess profits used to pay down mortgages	Percentage of estimated excess profits used to pay down mortgages
Atlanta	27	\$123,059	\$0	0%
Denver	45	\$253,926	\$33,330	13%
Philadelphia	18	\$186,942	\$0	0%
Santa Ana	34	\$140,793	\$28,672	20%
Total	124	\$704,720	\$62,002	9%

Source: HUD.

Note: The estimated excess profits are for discounted properties that HUD sold between February 1 and December 31, 2002, which nonprofits resold that same year.

HOC officials told us that although some of the remaining 21 nonprofits had withdrawn or were removed from the Discount Sales Program, others were still being evaluated by HOC staff and were continuing to purchase discounted properties. Moreover, these nonprofits retained all of the excess profits they had made. For example, one nonprofit still under review as of October 2003 made an estimated \$28,700 in excess profits on five discounted properties that it resold in 2002. The nonprofit did not pay down any mortgages, purchased 27 additional properties in 2003, and is still in the program. HUD's inability to enforce its requirements on excess profits in a vigorous and timely manner not only deprives homebuyers that have been overcharged but also puts the financial interests of other prospective homebuyers at risk.

Conclusions

HUD's Discount Sales Program is intended, among other things, to help make homes affordable for low- and moderate-income homebuyers. However, deficiencies in the program's design and implementation have undermined its ability to serve this end. Our analysis suggests that the program is of questionable benefit to most homebuyers. In addition, the HOCs' monitoring and enforcement efforts do not adequately ensure that

nonprofits are complying with requirements designed to protect homebuyers' financial interests. And despite the program's significant cost, HUD has not determined whether the program is meeting its objectives of expanding affordable housing opportunities, helping to revitalize neighborhoods, and reducing HUD's property inventory in a timely, efficient, and cost-effective manner.

Measures to address the cost, benefit, and compliance issues raised in this report are likely to be expensive or have adverse effects. For example, to reduce the cost of the program, HUD could reduce the size of its discounts, dedicate fewer staff resources to the program, or both. However, these actions would likely reduce the program's financial benefit to homebuyers and weaken HUD's ability to oversee participating nonprofits. Conversely, to increase financial benefits to homebuyers, HUD could increase the size of its discounts, but doing so would effectively raise the cost of the program.

Taken together, the program's problems and the lack of clear solutions raise serious questions about whether HUD should continue to operate it. We recognize that contemplating the termination of the program involves trade-offs. In the absence of the program, it is possible that some individuals and families would have difficulty purchasing suitable homes and that neighborhood conditions would suffer if HUD-owned properties were not rehabilitated or sold as quickly. However, unless significant changes are made to the program, it will likely continue to experience the problems raised in this report and by HUD's Inspector General.

Recommendations for Executive Action

GAO recommends that the Secretary of HUD take the following two actions:

- Evaluate options to improve the program's benefit to homebuyers, the agency's monitoring of nonprofits, and enforcement of excess profits requirements.
- Assess the extent to which the program is meeting its objectives.

If the Secretary determines that the current cost of the program plus the resources needed to improve it exceed the program's benefits, GAO recommends that the program be terminated.

Agency Comments and Our Evaluation

We provided HUD with a draft of this report for review and comment. In a letter from the Assistant Secretary for Housing (see app. I), HUD agreed with our recommendations to further assess the program and said it would proceed accordingly. Also, HUD disagreed with some aspects of our methodology and said that our analysis overstated the program's costs and understated its benefits. Lastly, HUD said that the report should acknowledge the significance of the multiple public policy objectives the program serves. However, HUD did not respond to our third recommendation concerning the possible termination of the program if, after further evaluation, HUD determines that the program's current costs plus the resources needed to improve it exceed its benefits.

More specifically, HUD stated that any conclusions about program costs should be based on actual program performance rather than on "hypothetical extrapolations." We designed our analysis to estimate the effect of the Discount Sales Program while holding constant the effect of other factors, such as neighborhood and property characteristics, that might also influence the ratio of the net revenue HUD receives from selling a property to the property's appraised value. To implement this approach, we developed a statistical model using data from actual HUD property sales and compared (1) the net revenue our model estimated HUD would have received for each discounted property had the property been sold through the regular process with (2) the net revenue our model estimated HUD would have received by selling the property through the Discount Sales Program. Each estimated value contained an error term that captured the effects of omitted variables unavailable for the modeling process. As appendix II of our draft report explained, comparing two estimated values removed the influence of the omitted variables from our comparison, leaving the effect of the program on HUD's net revenue. HUD said that its own preliminary comparison of net revenues from program and nonprogram property sales had shown that the loss in net revenue from the program was substantially less than our estimate indicated, and that our report significantly overstated the program's cost. Because HUD did not provide us details of its analysis, we cannot determine why HUD's results differed from ours. We continue to believe that isolating the effect of the program from other influences, rather than making comparisons that do not control for these factors, is the most appropriate way to estimate the impact of the Discount Sales Program on HUD's net revenue.

HUD also said that our conclusion that most homebuyers did not benefit financially from the program rested on the assumption that individual

homebuyers would have access to rehab financing on terms as favorable as nonprofits and would have the skills to oversee the construction. HUD disagreed with this assumption and said it believes that nonprofits have both the ability to obtain financing that is unavailable to average homebuyers and the capacity to oversee the rehab work at a cost that “may be less than that” charged by profit-motivated firms. As a result, HUD said that our report significantly understated the program’s benefit to homebuyers. Our draft report recognized the possibility that individual homebuyers might not be able to rehab a home as cheaply as a nonprofit. For this reason, we estimated the program’s financial benefits under two scenarios. The first assumed equal rehab costs for nonprofits and homebuyers; the second assumed that homebuyers would pay 25 percent more than a nonprofit for the same rehab work. Under both scenarios, our estimates indicated that most homebuyers did not benefit financially from the program. Our draft report also recognized that obtaining financing for rehab work and overseeing this work are obstacles for some homebuyers, and that these and other factors that are difficult to quantify may make the program either more or less beneficial from a homebuyer’s perspective. However, it is important to note that homebuyers financing properties purchased through the Discount Sales Program in effect pay financing costs for the rehab work because the cost of this work is included in the nonprofit’s selling price (i.e., the homebuyer’s purchase price) and therefore is reflected in the homebuyer’s mortgage costs. Furthermore, because more than half of the properties we reviewed received less than \$15,000 in rehab work—including some that received none at all—it is unlikely that the oversight costs for these projects would be very substantial.

Finally, HUD said that the Discount Sales Program serves several public policy purposes and was neither conceived as nor intended to be only a source of revenue for FHA. HUD stated that the program contributes in a “direct and positive manner” to the promotion of homeownership and the revitalization of neighborhoods and that our report should acknowledge the significance of these objectives. Our draft report did not indicate that the program was intended to be solely a source of revenue. In addition, our draft report recognized that the goals of the program include the expansion of affordable housing opportunities and neighborhood revitalization and included statements from HUD and nonprofit officials about how the program may help to improve neighborhood conditions. Furthermore, HUD’s comments do not recognize the potential of the agency’s regular sales process to help achieve the same goals. Nevertheless, we added language to the final report to reflect HUD’s views about the program’s

potential benefits. As our report notes, HUD has not provided any analysis to support its assertion that the program is contributing to the stated policy objectives. Accordingly, we believe that HUD needs to undertake such an analysis before making decisions about the program's future.

We are sending copies of this report to the appropriate congressional committees, and it will be available at no charge on GAO's Web site at <http://www.gao.gov>. If you or your staff have any questions about this report, please call me at (202) 512-8678. Key contributors to this report are listed in appendix IV.

Sincerely yours,

David G. Wood

David G. Wood
Director, Financial Markets and
Community Investment

Objectives, Scope, and Methodology

Our objectives were to assess (1) the cost of the Discount Sales Program to HUD, (2) the benefits of the program to homebuyers, and (3) HUD's efforts to monitor participating nonprofits and enforce program requirements. Our work focused on the approximately 1,200 properties HUD sold through the program in calendar year 2002 and the monitoring and enforcement activities the four HOCs performed in connection with those properties.

To determine the cost of the Discount Sales Program to HUD, we examined the program's impact on HUD's net revenue from property sales and the cost of administering the program. To determine the effect of the program on HUD's net revenue, we performed a statistical analysis of data from HUD's Single-Family Acquired Asset Management (SAMS) and the U.S. Census Bureau. This analysis allowed us to estimate how much less net revenue HUD received by selling properties through the program instead of its regular sales process, while controlling for other factors. Appendix II provides detailed information on our statistical model. Because HUD does not keep records that would identify the costs to administer the program, we asked HUD to estimate them. HUD developed its estimate by querying HOC and Office of Housing officials about the number of staff years they allotted to the program in calendar year 2002. HUD used this information and salary and benefit data to derive an approximate personnel cost for the program. HUD's estimate of administrative costs did not include comparatively minor expenses, such as travel and mailing costs. We did not assess the reliability of HUD's estimate.

To determine the benefits of the program to homebuyers, we examined the program's potential financial benefits and the types of homeownership services and assistance provided by participating nonprofit organizations. To determine the extent to which homebuyers benefited financially from the program, we performed a statistical analysis using data from HUD's SAMS, the Bureau of the Census, and the four HOCs. Our analysis was limited to 238 discounted properties that HUD sold between February 1 and December 31, 2002,¹ that nonprofits resold to homebuyers that same year. These were the only properties for which the HOCs had the rehab and resale data necessary for our analysis. This analysis allowed us to compare what homebuyers actually paid for the discounted homes to our estimate of what they would have spent had they purchased the homes under HUD's regular sales process and paid for the rehab work themselves. Our analysis

¹We used this time frame because HUD made significant changes to the program that became effective on February 1, 2002.

assumed that in the absence of the Discount Sales Program, a homebuyer would be able to purchase the same home and rehabilitate it to the same extent as the nonprofit. We also assumed that a homebuyer would inhabit the home during the rehabilitation and, therefore, would not incur housing expenses for two residences during that period. We performed the analysis twice using different assumptions about rehab costs each time. The first time we assumed that a homebuyer would incur the same rehab costs as a nonprofit; the second time we assumed that homebuyers would incur 25 percent higher rehab costs than a nonprofit. Appendix II provides detailed information on our statistical model. In assessing the program's financial benefits, we also reviewed HUD's rules and instructions for both the Discount Sales Program and the agency's regular sales process and interviewed officials from HUD's Office of Housing. To determine the types of services and assistance provided by participating nonprofits, we visited 6 nonprofits that were actively involved in the program and interviewed officials from these organizations. During our visits to the four HOCs, we reviewed the affordable housing plans for a judgmental sample of 17 nonprofits and interviewed the nonprofit coordinator at each HOC. We did not evaluate the impact of the Discount Sales Program on neighborhood conditions. However, we discussed this issue with HUD and nonprofit officials and visited six properties that nonprofits had either rehabbed or were in the process of rehabbing.

To assess HUD's efforts to monitor participating nonprofits, we reviewed HUD's program guidance and instructions, SAMS data on the number of discounted properties each nonprofit purchased in calendar year 2002, nonprofits' annual reports on these properties, and the results of the HOCs' desk and on-site reviews. We analyzed SAMS data, nonprofits' annual reports, and desk reviews to determine the extent to which (1) nonprofits submitted required monitoring information through their annual reports and (2) the HOCs' monitoring efforts identified noncompliance with requirements governing the resale price of discounted properties and the income level of the homebuyers. From the desk review information, which was current as of July 2003, we also determined the estimated excess profits earned by the nonprofit organizations that submitted annual reports. For each HOC, we used SAMS data and on-site review logs to determine how many of the nonprofits that purchased discounted properties were subject to an on-site visit. We also examined the results of these reviews and discussed them with cognizant HOC officials to determine how they were conducted and the types of problems they uncovered. Finally, we interviewed HUD Office of Housing and HOC officials about factors that hampered their ability to monitor nonprofits.

To assess HUD's efforts to enforce program requirements, we reviewed the agency's regulations and guidance to determine the major enforcement actions available to the HOCs. We interviewed officials from HUD's Office of Housing, Office of General Counsel, and the four HOCs about their ability to take these actions. At each HOC, we collected information on how frequently and in what situations they used these enforcement tools. We also collected information on the amount of excess profits nonprofit organizations used to pay down homebuyers' mortgages as of July 2003. Finally, we obtained data from each HOC showing the calendar year 2003 discounted home purchases of nonprofits that sold properties for more than program limits the previous year.

We tested the data we obtained from HUD's SAMS and the HOCs' desk reviews for reasonableness and completeness and found them to be reliable for the purpose of our analyses. In addition, we reviewed existing information about data quality and controls supporting SAMS and discussed the data we analyzed with agency officials to ensure that we interpreted them correctly.

We conducted this review from December 2002 through November 2003. We performed our work in accordance with generally accepted government auditing standards.

Statistical Models Used to Estimate Program Costs and Benefits

Two objectives of the study were to determine (1) the cost of the Discount Sales Program to HUD and (2) the benefits of the program to homebuyers. For the cost objective, the scope of the study included properties that HUD sold to nonprofit organizations in calendar year 2002. For the benefits objective, the scope included the properties that HUD sold to nonprofits between February 1 and December 31, 2002, that nonprofits rehabilitated and resold to homebuyers during the same year. The empirical analysis used to address these objectives was based upon two procedures. The first procedure was the estimation of a model for which the dependent variable is the fraction of the appraised value that HUD recovers for each property after taking the agency's selling costs into account. Controlling for a number of factors discussed below, the difference between the estimated net revenue HUD would have received by selling the properties at a discount versus an estimate of what HUD would have received if the property had been sold under HUD's regular sales process represented the cost of the Discount Sales Program to HUD. The second procedure was an estimate of the financial benefits a homeowner received from purchasing a rehabilitated Discounted Sales Program property from a nonprofit organization rather than purchasing the property through HUD's regular sales process and paying for the rehab work personally.

This appendix is organized in the following manner. First, there is a brief discussion of the data. Second, there is an explanation of the specification of the two econometric models that differ only in their dependent variables, as mentioned above. Next, there is a discussion of the estimation results of the two models. Finally, these results are used to calculate estimates of the costs and benefits of the Discount Sales Program.

Data

For our analysis, we obtained from HUD's Single-Family Acquired Asset Management System (SAMS) computerized files for the 65,039 properties sold by the agency during calendar year 2002. Each record provided financial information, such as selling price, appraised value, and various transactions costs. Each record also contained information on the structural characteristics of the property, such as the number of bedrooms and bathrooms. To describe the impact of neighborhood characteristics, we obtained data at the census tract level on the percent of the population living within an urbanized area, median household income in 1999, and median real estate taxes. The source of these data was the Census 2000 Summary File 3 prepared by the U.S. Census Bureau.

A review of the data identified a number of outliers and missing values. These observations were replaced using the means from the overall data set minus these observations. In addition, 3,776 observations were lost during the merger of the Census data because of the inability to identify the census tract in which they were located. As a result, these observations were not included in our analysis. In order to make the properties more comparable, we also restricted the set of properties to only those properties in census tracts in which at least one discount sale was made. Finally, we excluded some observations with extreme values for the dependent variable in our first model, which resulted in 5,189 observations being used in the regression analysis.

Specification of the Models

We developed two econometric models possessing the same set of explanatory variables. We used the first model to estimate the cost of the Discount Sales Program to HUD. In this model, the dependent variable is HUD's net revenue from the sale of a property divided by the property's appraised value. Net revenue equals HUD's selling price minus property taxes paid by HUD, management and marketing contractor costs, financing and closing costs (including discounts) paid by HUD, the listing broker fee, and the cost of any HUD sales incentives. We used the second model to estimate the benefits of the program to homebuyers. In this model, the dependent variable is simply HUD's selling price for a property divided by its appraised value. The explanatory variables used in both models are of four types: dummy variables identifying the homeownership center (HOC) that administered the sale; dummy variables describing a combination of HOC and discount level, for those properties sold through the Discount Sales Program; characteristics of the property; and characteristics of the neighborhood. We chose the final specification of the models to obtain a good fit while avoiding problems with multicollinearity.

We chose the property and neighborhood characteristics based on a review of the specifications employed in hedonic housing models.¹ Such models treat the housing market as an integrated series of submarkets for various housing characteristics such as house size and neighborhood quality. A set of housing and neighborhood characteristics can serve to describe a

¹See, for example, Ann D. Witte, Howard J. Sumka, and Homer Erekson, "An Estimation of a Structural Hedonic Price Model of the Housing Market: An Application of Rosen's Theory of Implicit Markets," *Econometrica*, Vol. 47 (September 1979): 1151-1173.

product like housing because individual housing units can be differentiated from one another in many ways.

Selling price is the amount paid to HUD by either the nonprofit or the private individual purchasing the property. Property taxes are the annual property tax multiplied by the number of days the property was owned by HUD divided by 365. Management and marketing contractor costs encompass all fees and reimbursable costs HUD pays to these contractors. Financing and closing costs paid by HUD include any discount granted to a nonprofit organization. The selling fee is the commission that HUD paid to the selling broker. This fee is generally zero for properties sold to nonprofits. All HUD properties are placed with a listing broker, so this generates a listing broker fee. Incentives are cash back allowances that HUD periodically pays to homebuyers who close on an executed sales contract relatively quickly—for example, within 30 to 60 days. Appraised value is the amount at which the property was appraised before the sale.

The explanatory variables belong to one of four groups of variables: those identifying the HOC that administered the sale; those describing a combination of HOC and discount level, for those properties sold through the Discount Sales Program; those describing characteristics of the house; and those describing characteristics of the neighborhood. This specification allows the net revenue as a fraction of the appraised value for properties sold through the regular program to vary by HOC, and it allows the effect of the Discount Sales Program on HUD's net revenue to vary by HOC and by discount level. We defined a set of HOC dummy variables that take on a value of 1 for all sales (discounted and not discounted) administered by that HOC, with Atlanta as the omitted category, and 0 otherwise. We then defined a set of dummy variables that represented combinations of HOC and discount program level. For example, there is a dummy variable that takes on a value of 1 for all sales with a 10 percent discount made by the Atlanta HOC and 0 otherwise, etc. In this way, the coefficient on that variable represents the difference in the fraction of the appraised value obtained on property sales with a 10 percent discount and made by the Atlanta HOC, compared with the fraction obtained by the Atlanta HOC on sales made through the regular program. Similarly, the coefficient on the dummy variable that takes on a value of 1 for all sales with a discount level of 30 percent made by the Santa Ana HOC represents the difference in the fraction of the appraised value obtained on property sales made at a 30 percent discount and made by the Santa Ana HOC,

compared with the fraction obtained by the Santa Ana HOC on sales made through the regular program.²

There are three variables that provide characteristics for each property. These variables measure the property's number of bedrooms, bathrooms, and stories. Although the likely association between those variables and HUD's net revenue from a property sale relative to the property's appraised value is not clear-cut, we anticipated that there may be a positive association for the number of bedrooms and bathrooms. HUD's costs associated with property management and sale include a fixed cost component not related to property value as well as a component that varies with selling price. Accordingly, if properties with more bedrooms and bathrooms tend to be valued more, increasing both their selling prices and appraised values, then HUD's net revenue relative to the appraised value will be higher for higher-valued properties because HUD's fixed costs will be lower relative to the appraised value. Because the relationship between number of stories and market value is less clear, we had no clear expectation for the sign of the coefficient for that variable. Because any effect of these variables on market value is likely to similarly affect both selling price and appraised value, for the equation with selling price divided by appraised value as the dependent variable we had no clear expectation of the signs of the coefficients of these variables. However, we included them to keep our equations consistent and because these variables may exhibit statistically significant effects if HUD is able to obtain more accurate appraisals for certain types of properties.

Finally, there are four variables for neighborhood characteristics: the percent of the population in the census tract living within an urbanized area, median household income in 1999, median real estate taxes, and whether the property is located in a revitalization area. As for the property characteristics, we anticipated that to the extent that these neighborhood characteristics are associated with higher (lower) property values, they would be positively (negatively) associated with HUD's net revenue from a property sale relative to that property's appraised value because for higher- (lower-) valued properties HUD's fixed costs will be lower (higher) relative to appraised values. Accordingly, we anticipated positive coefficients in the equation for which the dependent variable is HUD's net revenue relative to

²There were no discounted sales at the 15 percent level made by the Atlanta HOC, and as a result the dummy variable combining 15 percent discount with the Atlanta HOC is also omitted.

appraised value for the percentage of the population living within an urbanized area, median income, and median real estate because all of these variables are likely to be positively associated with property value. In contrast, we anticipated a negative coefficient for location in a revitalization area because that variable may indicate lower property values that would raise the ratio of HUD's fixed costs to a property's appraised value and because HUD may also incur additional costs to maintain properties in those areas. Again, similar to the property characteristics, we had no clear expectations for the signs of the neighborhood characteristics in the equation in which the dependent variable is HUD's selling price relative to the appraised value because any effect of these variables on property value is likely to similarly affect selling price and appraised value. But, for the reasons cited above, we included them in the equation.

Table 7 presents the variable names and descriptions, along with mean values of the explanatory variables. In a previous version of the model that we estimated using a data set representing all usable observations of HUD property sales, rather than the data set containing only sales made in census tracts in which discount sales were made, we included as variables the year in which the structure was built and the average age of homes in the census tract. These variables were significant at that time, but they became insignificant in the final model when we limited our data set, so we dropped them from the analysis. Although the rate of change in house prices is another variable that may have some predictive value, we did not include it in our models because information on the rate of house price change was not available at the census tract level. Also, according to HUD officials, the average time between the appraisal and the sale of a property is about 3 months, so in most cases we did not anticipate that there would be much price appreciation or depreciation resulting from market conditions.

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Table 7: Variable Names, Descriptions, and Mean Values

Variable name	Variable description	Mean value
HOC dummy variables		
Santa Ana HOC	1 if property was sold with or without a discount by the Santa Ana HOC, else 0	0.4039
Denver HOC	1 if property was sold with or without a discount by the Denver HOC, else 0	0.1243
Philadelphia HOC	1 if property was sold with or without a discount by the Philadelphia HOC, else 0	0.2249
Discount Sales Program category dummy variables		
Santa Ana, 10	1 if property sold at 10 percent discount level by the Santa Ana HOC, else 0	0.0412
Santa Ana, 15	1 if property sold at 15 percent discount level by the Santa Ana HOC, else 0	0.0019
Santa Ana, 30	1 if property sold at 30 percent discount level by the Santa Ana HOC, else 0	0.0250
Denver, 10	1 if property sold at 10 percent discount level by the Denver HOC, else 0	0.0191
Denver, 15	1 if property sold at 15 percent discount level by the Denver HOC, else 0	0.0120
Denver, 30	1 if property sold at 30 percent discount level by the Denver HOC, else 0	0.0041
Philadelphia, 10	1 if property sold at 10 percent discount level by the Philadelphia HOC, else 0	0.0397
Philadelphia, 15	1 if property sold at 15 percent discount level by the Philadelphia HOC, else 0	0.0058
Philadelphia, 30	1 if property sold at 30 percent discount level by the Philadelphia HOC, else 0	0.0224
Atlanta, 10	1 if property sold at 10 percent discount level by the Atlanta HOC, else 0	0.0399
Atlanta, 30	1 if property sold at 30 percent discount level by the Atlanta HOC, else 0	0.0150
Property characteristics		
Bedrooms	The number of bedrooms in the structure	3.1134
Bathrooms	The number of bathrooms in the structure	1.8071
Stories	The number of stories in the structure	1.3472
Neighborhood characteristics		
Urban area	Percent of population in the census tract living within an urbanized area	92.9976
Median income	Median household income in census tract (1999)	38.6993
Median real estate taxes	Median real estate taxes in census tract	1.2862
Revitalization area	1 if property is located in a HUD-designated revitalization area, else 0.	0.2631

Source: GAO.

Estimation Results

We estimated the two models using ordinary least squares due to its ease of calculation and interpretation. Table 8 presents the estimated coefficients, their standard errors, and the summary statistics.

In general, both models were consistent with our expectations. In the model for net revenue relative to appraised value, the coefficients on the Discount Sales Program category showed the expected pattern. That is, for each HOC, coefficients became more negative at higher discount levels.

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In both models the coefficients for the characteristics for the property possessed the same sign. In general, a higher fraction of the appraised value was obtained from larger homes, as measured by more bedrooms and bathrooms, as well as homes with fewer floors. The fraction of the appraised value obtained by HUD tended to be higher for properties located in more urban areas and where median real estate taxes were higher. In the model for selling price relative to appraised value, the coefficient for median household income was negative and statistically significant at less than the 0.01 percent level. However, in the model for net revenue relative to appraised value, the coefficient on this variable was statistically insignificant.

Table 8: Coefficients from Estimated Models

Explanatory variable name	Net revenue relative to appraised value	Selling price relative to appraised value
Intercept	0.7975 (0.0139)	0.9085 (0.0136)
HOC dummy variables		
Santa Ana HOC	0.0461 (0.0056)	0.0231 (0.0054)
Denver HOC	-0.0444 (0.0079)	-0.0520 (0.0077)
Philadelphia HOC	-0.0026 (0.0074)	0.0174 (0.0072)
Discount Sales Program category dummy variables		
Santa Ana, 10	-0.1448 (0.0100)	-0.0874 (0.0098)
Santa Ana, 15	-0.1959 (0.0437)	-0.1064 (0.0427)
Santa Ana, 30	-0.2726 (0.0131)	-0.0506 (0.0128)
Denver, 10	-0.0622 (0.0152)	-0.0088 (0.0149)
Denver, 15	-0.1147 (0.0186)	-0.0385 (0.0182)
Denver, 30	-0.1744 (0.0309)	0.0525 (0.0303)
Philadelphia, 10	-0.1053	-0.0785

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Explanatory variable name	Net revenue relative to appraised value	Selling price relative to appraised value
	(0.0109)	(0.0106)
Philadelphia, 15	-0.1267	-0.0903
	(0.0258)	(0.0252)
Philadelphia, 30	-0.2718	-0.0611
	(0.0140)	(0.0137)
Atlanta, 10	-0.0851	-0.0536
	(0.0106)	(0.0103)
Atlanta, 30	-0.2595	-0.0173
	(0.167)	(0.164)
Property characteristics		
Bedrooms	0.0052	0.0063
	(0.0022)	(0.0022)
Bathrooms	0.0155	0.0083
	(0.0034)	(0.0033)
Stories	-0.0280	-0.0081
	(0.0054)	(0.0053)
Neighborhood characteristics		
Urban area	0.0007	0.0007
	(0.00009)	(0.0001)
Median income	0.0003	-0.0006
	(0.0002)	(0.0002)
Median real estate taxes	0.0177	0.0254
	(0.0032)	(0.0031)
Revitalization area	-0.0244	-0.0091
	(0.0054)	(0.0053)
Summary statistics		
R ²	0.28	0.09
Number of Observations	5,189	5,189

Source: GAO.

Note: Standard errors are in parentheses.

Program Costs

We used the estimated coefficients for the Discount Sales Program variables from the model for net revenue relative to appraised value to estimate the cost of the program to HUD. We made this estimate by comparing the (1) net revenue that our model predicted HUD would have received for each discounted property had it been sold through the regular sales process with (2) net revenue our model predicted HUD would have

received by selling it through the Discount Sales Program. Even though we knew the actual amount HUD received by selling the property through the Discount Sales Program, we compared two estimated values in order to be consistent. Each estimated value contained an error term that captured the effects of omitted variables unavailable for the modeling process. By comparing two estimated values, we removed the influence of the omitted variables from our comparison, leaving the effect of the Discounted Sales Program.

This analysis was conducted using 1,194 discounted properties that were sold during calendar year 2002. The values of the Discount Sales Program dummy variables reflect the estimate of the difference in the fraction of appraised value obtained by HUD for each combination of discount level and HOC. That is, for a given property's program characteristics—discount level and HOC—these estimates represent the difference in value HUD obtains compared to the case in which that property had been sold through the regular program. Because we included HOC dummies to capture otherwise unmeasured factors that might vary by region, the program characteristic dummy variables describe incremental revenue differences associated with each discount level as compared to the level of nondiscount sales in each HOC. For example, if a property was sold by the Philadelphia HOC at a 15 percent discount, the estimated difference in the net revenue value would be about –13 percent of appraised value. The relevant coefficient in table 8 is –0.1267. Similarly, if a property was sold by the Santa Ana HOC at a 15 percent discount, the estimated difference in the net revenue value would be about 20 percent of appraised value. The relevant coefficient in table 8 is –0.1959.

We also estimated a range of costs using confidence intervals around the estimates for the sales category dummy variables. We did this by multiplying each coefficient estimate by 1.645 times its associated standard error. We then added and subtracted this amount from the coefficient estimate to create a 90 percent confidence interval around each estimate. We then recalculated program costs assuming that the estimates associated with the lower and upper bounds of the confidence interval reflected the difference between the value HUD obtains through the Discount Sales Program as compared to the value obtained through the regular sales process.

Benefits to Homebuyers

In the model for selling price relative to appraised value, the benefit to the homebuyer of purchasing a property from a nonprofit organization was

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taken to be the estimated price a homeowner would have paid to buy the house through HUD's regular sales process, minus the estimated financing and closing costs that HUD would have paid in that situation, plus the rehabilitation costs, minus the actual sales price paid to the nonprofit. This analysis was conducted using 238 observations for discounted properties purchased by nonprofits between February 1 and December 31, 2002, and resold to homebuyers that same year. These were the only properties for which data on the nonprofits' rehabilitation costs and the selling price to the final homeowners were available. We performed the analysis twice using different scenarios. In the first scenario, we assumed that the rehabilitation costs incurred by a homebuyer operating outside of the Discount Sales Program would be the same as the rehabilitation costs actually incurred by the nonprofit. In the second scenario, we assumed that a homebuyer's rehabilitation costs would be 25 percent higher than those incurred by the nonprofit. Under both scenarios, we assumed that the financing and closing costs HUD would pay for under its regular sales process were equal to 3 percent of the estimated selling price.

Because these properties were originally bought from HUD by a nonprofit organization, we needed to estimate the prices homebuyers would have paid to purchase the properties directly from HUD through the regular sales process to calculate the difference in price paid by homeowners purchasing a property after it had been rehabilitated under the Discount Sales Program. In a manner parallel to our estimate of net revenue described earlier, we used the values of the estimated Discount Sales Program dummy variables from our second model to make this calculation.

Comments From the Department of Housing and Urban Development



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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

JAN 13 2009

Mr. Steven K. Westley
Assistant Director
Financial Markets and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Mr. Westley:

Thank you for the opportunity to comment on the draft report entitled Single Family Housing: Cost, Benefit, and Compliance Issues Raise Questions about HUD's Discount Sales Program (GAO-04-208).

The Department appreciates the effort undertaken by your staff to perform a thorough analysis of the cost versus benefits of the Nonprofit Discount Sales Program (Discount Program) and the fruitful discussion between our agencies during the exit conference. We agree with the GAO position that the Discount Program would benefit from an updated evaluation and an assessment of methods to improve monitoring and enforcement. Therefore, the Department accepts the Report's two recommendations and will proceed accordingly. However, we wish to clarify our position that the Discount Program serves several public policy purposes and was neither conceived nor intended to be only a source of revenue for the FHA.

One important objective of the program is to expand affordable housing opportunities for homeownership in targeted areas. The Report contends that minimal savings are accruing to the homebuyer from this program especially from sales at shallow discounts. However, this contention is predicated on the assumption that the individual homebuyer would have access to financing for rehabilitation on terms as favorable as the nonprofits and the skills to oversee the construction. We disagree with this assumption and think that the nonprofits have the ability to obtain financing for rehabilitation that is unavailable to average homebuyers and the capacity to oversee the project at a reasonable cost (10%) that may well be less than that charged by profit motivated developers. Therefore, we feel that the conclusions as to the actual benefit accruing to the homebuyer significantly understate the benefit.

Additionally, the promotion of homeownership and the revitalization of neighborhoods are important goals of the Department. The Discount Program contributes in a direct and positive manner to the achievement of both these objectives. Homeownership and property rehabilitation both have stabilizing effects on neighborhoods. It is important to note that outside of this program, forty-three percent of FHA sales in revitalization areas are to investors; therefore it is possible to conclude that

the proportion of rental to homeownership would be substantially higher absent the Discount Program.

Finally, while the effects are not directly quantifiable, an increased percentage of homeownership in a neighborhood improves the stability of the area and directly contributes to property values. These factors reduce the risk of default and foreclosure in the subject neighborhood and therefore have a positive financial impact on the FHA Insurance Fund.

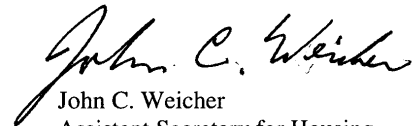
While the Department understands that the intent of the GAO review was to measure the effectiveness of the Nonprofit Discount Program in terms of cost and direct benefit to the ultimate purchaser, we request that you consider the other goals that the program is intended to accomplish and acknowledge their significance in your final report.

As expressed in the exit conference, we continue to have concerns about the methodology employed to estimate costs and have additional questions on the accuracy of conclusions of the Report. We believe that any conclusions regarding costs of the Discount Program should be based on actual program performance rather than hypothetical extrapolations. For example, we have done some preliminary analysis of actual sales in the Discount Program, comparing net recoveries to those on homes not in the Discount Program. The cost/loss due to lower net recoveries on program properties is only about 60 percent of the (average) GAO estimate. Therefore, the Department feels that the report overstates the costs and losses significantly. We intend to do a more comprehensive review of the cost analyses contained in the report shortly and will be pleased to provide you with our results as soon as they are available.

In addition, the Department intends to include a comprehensive analysis of the actual cost of the Discount Program as a part of the evaluation we plan to conduct. We will be pleased to discuss our methodology and the results of this analysis with the GAO when it is available.

Again, we appreciate the opportunity to comment on the draft report.

Sincerely,



John C. Weicher
Assistant Secretary for Housing
Federal Housing Commissioner

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