Audit Report

District Inspector General for Audit
New England District

Report: 98-BO-111-0002 *Issued: March 31, 1998*

TO: Art Agnos, Acting General Deputy Assistant Secretary for Housing-Federal Housing Commissioner, GDH

FROM: William D. Hartnett, District Inspector General, Office of Audit, 1AGA

SUBJECT: Section 8 Rent Increases under the Budget-based Method

We performed a review of rent increases for Section 8 Budget-based projects. We wanted to find out if projects which had undergone rental conversions were properly approved and if a pattern of Section 8 assisted projects with rents significantly exceeding 120 percent of Fair Market Rents existed. This report contains two findings. We are recommending that you provide guidance to your staff regarding rental structure conversions and rent increases for capital improvements.

Within 60 days please furnish us, for each recommendation in this report, a status report on: (1) the corrective action taken: (2) the proposed corrective action and the date to be completed or, (3) why action is not necessary. Also, please furnish us copies of any correspondence or directives issued because of the audit.

We thank you and your staff for the courtesy shown to us during the audit. If you have any questions, please call me or William Gelpke, Assistant District Inspector General for Audit at (617) 565-5259.

Executive Summary

We completed a review of the Section 8 Rental Assistance Program. Our overall objective was to identify any projects whose rental structure had been converted from an annual adjustment basis to an operating budget basis and to determine if the conversions were properly approved. We also determined if a pattern of budget-based Section 8 assisted projects with rents significantly exceeding 120 percent of Fair Market Rents existed and if the Department was funding capital improvements. Our review focused on Section 8 Budget-based projects whose rents exceeded 150 percent of FMRs.

HUD Needs To Prevent Rents From Significantly Exceeding 120 Percent of Fair Market Rents

Rental structures at five projects were converted from an annual adjustment basis to an operating budget basis. Approval of these conversions was made by individuals without proper authority resulting in misappropriation of government funds. Further these acts impeded HUD's ability to comply with Section 106 of the HUD Reform Act of 1989 requiring that waivers of regulations be published.
As a result, if rents cannot be rolled back, $36.4 million in scarce Section 8 funds in excess of 120 percent of fair Market Rents will need to be reserved for these projects from September 30, 1997 to the end of their Section 8 Housing Assistance Payment Contracts.

Fifty-four budget-based projects have rents in excess of 150 percent of the Fair Market Rents. While representing only 4.5 percent of the 1200 projects whose rents exceed 150 percent of Fair Market Rents, these 54 projects are costing the Department annually up to $17.4 million more than projects whose rents are limited to 120 percent of Fair Market Rents. We also found that some asset managers are granting rent increases in excess of 120 percent of FMR for capital improvements which is contrary to Department policy.

We are recommending that you promulgate guidance to prevent rent structure conversions without proper approval, and prevent rent increases from significantly exceeding 120 percent of Fair Market Rents. Further, the Department's policy on funding capital improvements should be clarified.

On January 22, 1998, we met with the Assistant Secretary's staff to discuss the results of our audit. On February 28, 1998, we furnished our draft for comment. On March 27, 1998, we received the Acting General Deputy Assistant Secretary's comments and have considered them in the preparation of our final report.

The Acting General Deputy Assistant Secretary agreed to remind all offices of HUD's conversion policy and publicize a consistent policy regarding the allowability of rent increases for capital improvements. Due to the limited number of cases found, the Assistant Secretary did not feel improved control systems were necessary. Based upon this assurance, we have removed our draft report recommendations calling for additional or improved control systems.

Our draft report contained a recommendation to obtain a formal legal opinion concerning the exclusion of Section 236 projects from the requirement to reduce rents to 120 percent of Fair Market Rents upon renewal of their Section 8 contracts. Although Housing has agreed to request further review by OGC, we have removed this recommendation from the final report because the Office of Inspector General has requested Office of General Counsel's opinion on this matter.

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Abbreviations:

FMRs	Fair Market Rents
OIG	Office of Inspector General
FHA	Federal Housing Administration
HAP	Housing Assistance Payment
AAF	Annual Adjustment Factor
RISO	Rhode Island State Office
NHA	National Housing Act
OGC	Office of General Counsel
CFR	Code of Federal Regulations
IOI	Identity Of Interest
SNAP I	Savannah Neighborhood Action Project I
SNAP II	Savannah Neighborhood Action Project II

Introduction

The purpose of the Section 8 program is to provide low-income families with decent, safe and sanitary rental housing through the use of a system of housing assistance payments (HAP) provided to public housing agencies or to private owners either directly from HUD or through HUD contract administrators. The Section 8 program subsidizes different types of housing (new construction, substantial rehabilitation, moderate rehabilitation, existing) and assists more than 3 million families. The HAP subsidies are either project-based or tenant-based. Project-based HAP subsidies are linked to a particular building while tenant-based HAP contracts are linked to a particular family. For the purpose of this review, we examined rent structures at those projects receiving Section 8 project-based subsidies.

The rents at projects receiving Section 8 project-based subsidies are determined by the rental structure which is established at the beginning of the project. Rental structures are either based on an Annual Adjustment Factor (AAF) or are based on the project's operating budget. Our review examined only those projects whose rents were based on an operating budget.

At the request of the owner, HUD will renew Section 8 contracts which expire or terminate during FY 1997 for one year at the current rent levels, but not more than 120 percent of the associated Fair Market Rents (FMRs). However, for projects insured by HUD under Sections 202, 811, or 515 of the National Housing Act of 1937 or a project whose primary financing or mortgage insurance is provided by a public agency (typically a Housing Finance Agency), the contract is to be renewed at current rents which may exceed 120 percent of the FMRs. HUD has also exempted projects insured under Section 236 of the National Housing Act of 1937 from the requirement to reduce rents to 120 percent of FMRs upon renewal.

These provisions were enacted to assist HUD in renewing all Section 8 contracts without further exacerbating the Section 8 funding crisis. By the end of fiscal year 1998, Section 8 contracts for 1.8 million units will expire. In testimony before the Appropriations Subcommittee on May 13, 1997, the Secretary stated:

> *To me, the mission of HUD -- and the larger mission of this Subcommittee -- has never been more vital than it is today. The need to create safe, decent and affordable housing for all Americans; the need to create jobs and bring opportunity to our communities; the need to empower our people and help them get the skills they need to lift themselves up -- these challenges are just as great and just as pressing as they have ever been....*

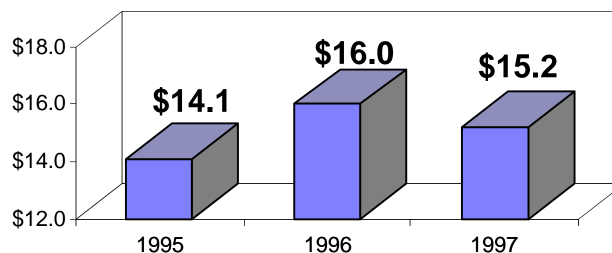
> *We recognize that these challenges come at a time when the federal government has fewer and fewer resources. If we had to make a choice between fiscal prudence and meeting the needs of troubled Americans, the choice would be difficult – indeed. ...Failure to renew all expiring Section 8 contracts would likely put over 4 million people in the street. Full renewal will help us maintain America's historic commitment to providing decent, safe affordable housing well into the next century.*

Section 8 Funding Crisis

Since Congress created the Federal Housing Administration (FHA) in 1934, HUD and its predecessor organizations have administered a variety of Federal programs that have increased the supply and affordability of housing for millions of families. Many insured and assisted housing projects placed in service during the 1970s and 1980s for low-income families are now staring at physical decline or have proven to be far too expensive. The coupling of Section 8 subsidy with FHA insurance has resulted in the Federal Government taking on an overwhelming majority of the financial risk and oversight responsibility for the well being of the projects and their residents while removing the incentives for owners to maintain properties, invest capital or keep down costs.

FHA insurance protects private lenders from losses resulting from borrower defaults on the mortgages for these properties. When a borrower defaults, the lender assigns the mortgage to HUD and receives an insurance claim payment from HUD for the unpaid mortgage amount. About 75 percent of FHA-insured projects receive some form of direct subsidy from HUD including interest rate subsidies and/or Section 8 rental assistance. The project-based Section 8 subsidy is covered by contracts between HUD and the project owners. The owners agree to house lower-income tenants in exchange for rent subsidies for specific units. After several years of subsidy increases, the Section 8 subsidy payments for both annual adjustment factor-based subsidy and budget-based subsidy decreased to $15.2 billion (unaudited) for the fiscal year ended September 30, 1997.

Section 8 Subsidy Payments
(in billions)



Simply reducing the Section 8 subsidy to market rents would cause many project owners to default on their FHA-insured mortgages leaving enormous mortgage insurance claims, tenants without adequate affordable housing and communities devastated by deterioration of housing when the owners walk away from projects. HUD has enacted a Demonstration program called Mark-to-Market in which Section 8 contracts are renewed with rents remaining level for a six month period. During these six months, the mortgage at the property and the rental assistance plan are restructured in conjunction with a rehabilitation plan. Generally, the rents are reduced to market levels upon completion.

Background

At two projects in Rhode Island, we found that rents at these Budget-based Section 8 projects significantly exceeded local FMRs. Rents were approved at rates exceeding 500 percent of FMRs. The State Office converted these projects from annual adjustment factor-based subsidies to budget-based subsidies and then raised the rents to an amount necessary to fund the project owners' requests regardless of the disparity between FMRs and the approved rents. This was done by the HUD staff despite HUD's current efforts to limit rents to no more than 120 percent of FMRs. We found that the process used to convert these properties from annual adjustment factor-based subsidy to budget-based subsidy violated Department regulations. Further, in view of the shortage of Section 8 funding, we were concerned with rent increases which significantly exceed 120 percent of FMRs.

Additionally, in these two cases, significant portions of the rent increases were used to pay for capital improvements at the projects. Increasing rents above FMRs to finance capital improvements is contrary to HUD policy as confirmed by:

- Former Deputy Assistant Secretary for Multifamily Housing, March 22, 1995, memorandum to all Housing Directors that stated:

  > *"There will be no Section 8 rent increases approved for capital improvements, except when the Field Office determines that rents are no higher than FMR. Where this results in continuation of unsafe conditions, your office should consider abatement and other steps to enforce Housing Quality Standards."*

- Another former Deputy Assistant Secretary for Multifamily Housing, May 9, 1997 letter to the Rhode Island Director of Multifamily Housing that stated:

". . . It is not appropriate for your office to increase rents for repairs or rehabilitation that place the burden of paying for an owner's regulatory compliance on HUD."

Based upon our experience in Rhode Island, we were concerned that other State and Area Offices might be raising rents to inappropriate levels and might be converting other annual adjustment factor-based projects to budget-based projects; thus contributing to the Section 8 funding crisis. Accordingly, on June 10, 1997, the Inspector General advised to the Assistant Secretary for Housing-Federal Housing Commissioner that the OIG would commence a national review to determine whether excessive rent adjustments such as those within the Rhode Island State Office's (RISO) jurisdiction have occurred elsewhere, and if so, what is their cumulative impact.

Audit Objective

The purpose of our audit was to determine if there was a pattern of rents in budget-based Section 8 projects significantly exceeding FMRs. If such a pattern exists, we also wanted to determine the cumulative impact of such a pattern.

Scope & Methodology

We downloaded the database of Section 8 rental information from HUD's website, classified the universe of projects to be examined based upon rents as a percentage of FMRs, location and type of project. We examined those Section 8 projects that:

- were funded directly by HUD,
- had rents in excess of 150 percent of the FMRs
- were not insured under Sections 202, 515 or 811

HUD's database does not differentiate between AAF-subsidized projects and Budget-based projects. Rents at AAF projects are adjusted on the anniversary date of the HAP contract using adjustment factors published annually in the Federal Register. Thus, rent adjustments tend to be "automatic" and are not normally dependent on decisions made at the local levels. Rents at Budget-based projects are determined by the amount of the owner's proposed operating budget which is approved by the local State Offices and can be influenced by project owners and Asset Management Branches. Asset Management Branches are given a wide latitude in approving operating budgets.

Our initial analysis identified 1219 projects across the country which had rents in excess of 150 percent of FMRs.

Projects Examined

Field Office	Numbers With Rents Exceeding 150% of FMRs
New England	95
New York/New Jersey	145
Mid Atlantic	177
Southeast/Caribbean	189
Midwest	295
Southwest	54
Great Plains	103
Rocky Mountains	87
Pacific/Hawaii	34
Northwest/Alaska	39
Capital	1
Total	**1219**

We reviewed each of the projects from our initial analysis as well as several others that met our criteria to determine if they were AAF or budget-based. Upon examination of the Asset Management files, we learned that 91 percent of these contracts were subject to annual adjustment factor, another 4.5 percent had rents as a percentage of FMRs reduced because of either increases in the FMRs or the rents had been reduced upon renewal of the contract. From this review, we discovered 60 projects or 4.5 percent had budget-based rent structures whose rents were in excess of 150 percent of the FMRs.

For these 60 projects, we obtained the rent schedules and the FMRs for our audit period of October 1, 1995 to September 1, 1997. We also interviewed the Chiefs of the Asset Management Branches to determine if their office(s):

- had converted the rental structure at projects from Annual Adjustment Factor (AAF) to Budget-based since 10/1/95,
- was aware of any budget-based projects whose rents significantly exceed FMRs (i.e., 150 percent and above),
- had renewed Section 8 Contracts for budget-based projects whose rents were greater than 120 percent of the FMRs,
- had granted rent increases to any budget-based project for capital improvements since 10/1/95,
- had granted significant rent increases to any budget-based project in which the annual cost of rents at the project increased by 20 percent.

We scheduled the approved rent potential in existence at 10/1/95, 10/1/96 and 9/1/97 to compare approved rents with the FMRs for that jurisdiction.

For projects whose rental structures had been converted from AAF to budget-based, we reviewed the reasons behind the conversions, the current physical and operational condition of the projects, the releases from the reserves for replacement, the housing assistance payment contracts and any Management improvement plans.

We visited Headquarters to discuss the existence and evolution of internal controls over approving rent increases. We also discussed the current policy regarding funding of capital improvements.

We performed the audit field work from May 1997 through January 1998. We conducted the audit in accordance with generally accepted governmental auditing standards.

Findings

Finding 1

The Department Did Not Properly Approve Conversions Of Subsidy Structure

The Department did not properly approve the conversion of five Section 8 subsidized projects from the Annual Adjustment Factor (AAF) rent structure method to the Budget based rent structure method. The approval of these five conversions was made by individuals without proper authority, causing a misappropriation of Government funds. Further, these acts impeded HUD's ability to comply with Section 106 of the HUD Reform Act of 1989 requiring that waivers of regulations be published. As a result $36.4 million in scarce Section 8 funds has been reserved for rents in excess of 120 percent of Fair Market Rents (FMRs) through the end of their associated Housing Assistance Payment (HAP) contracts. One current court interpretation of the law says HUD cannot reduce the rents at these properties before the end of the HAP contract without refinancing the properties so that the owners' payments are lower. The Department is contesting this interpretation.

Converting Rent Structures Constitutes A Waiver

Conversion of a property's rent structure from rents dependent upon the AAF to rents dependent on the operating budget constitutes a waiver. According to 42 U.S.C. Section 3535(q) any waiver of regulations must be: 1) in writing specifying the grounds for approving the waiver, 2) made by the Secretary or an individual of Assistant Secretary rank or equivalent rank who is authorized to issue the regulation to be waived, and 3) made available to the public via a notice in the Federal Register identifying the circumstances warranting a waiver of the regulation and the official granting the waiver. In each of the five cases, the official granting the waiver did not have the authority to grant the waiver, nor was waiver published in the Federal Register identifying the official authorizing the waiver and the circumstances warranting a waiver of the regulations.

Conversions Were Approved By Officials Without Authority

Four of the conversions were approved by a former Director, Office of Asset Management and Disposition located in HUD Headquarters, Washington, DC. When interviewed, the Director stated that he did not have the authority to approve conversions for projects subsidized under Section 881 of the Code of Federal Regulations. One of the letters requesting conversion of the rental structure specifically stated that the project under discussion was subsidized via Section 881. On December 18, 1997, the former Assistant Secretary for Housing concluded that the approval of these four conversions was made by individuals without authority, caused a misappropriation of government funds and impeded HUD's ability to comply with Section 106 of the HUD reform Act of 1989 requiring that waivers be published.

The fifth conversion was approved by a former Director of Housing Management at a State Office using a prior conversion in the office's jurisdiction as guidance. The rental structure at this property was converted to rehabilitate the property. The Director believed it was possible because conversion of another property in the office's jurisdiction had been approved by a former Director, Office of Asset Management and Disposition from HUD Headquarters in the preceding year. We are awaiting the Assistant Secretary's decision regarding propriety of this conversion.

Summary Of Conversions

According to the requests for conversion, the changes in rental structures at these properties were performed to avoid the assignment of the FHA-insured mortgage. HUD works diligently to prevent assignments of FHA-insured mortgages; however, often, the price of this diligence has been to increase Section 8 subsidies. A summary of the conversion statistics is shown below. Details surrounding the rental structure conversion of these five projects is in Appendix 1 of this report.

Project Name	FHA Number	Units	Pre-Conversion Rent	Date of Conversion	Post Conversion Rent
SNAP I	061-35342	100	$ 644,700	04/05/94	$ 778,668
SNAP II	061-35361	89	$ 553,464	04/05/94	$ 715,608
Barbara Jordan I	016-57008	193	$2,292,315	01/25/95	$4,597,428
Melrose Apts.	016-57008	42	$ 342,384	09/01/96	$1,517,616
Seven Oaks	084-35225	78	$ 376,704	04/29/94	$ 692,280
Totals		502	$4,209,567		$8,301,600

Several of these properties have received additional rent increases since conversion. At their current maximum rent level, we estimate that these projects

may require over $25 million in scarce Section 8 funds above 120 percent of FMRs from September 30, 1997 to the end of their respective contracts if rents are not rolled back to pre-conversion levels.

Name	Maximum Annual rents	120% of FMRs	Rents in Excess of 120% of FMRs	HAP Expiration Date	Amount over 120% of FMRs	
					Projected 9/30/97 to End of HAP	Total from Conversion Date to End of HAP
SNAP I	$ 918,792	$ 807,811	$ 110,981	01/31/03	$ 592,607	$ 684,604
SNAP II	$ 830,292	$ 734,832	$ 95,460	11/08/03	$ 583,221	$ 630,281
Barbara Jordan	$4,505,760	$2,004,912	$2,500,848	06/30/04	$16,889,289	$ 24,591,369
Melrose Apts.	$1,517,616	$ 401,026	$1,116,590	09/25/03	$ 6,687,306	$ 8,920,487
Seven Oaks	$ 729,360	$ 504,058	$ 225,302	10/28/00	$ 693,808	$ 1,606,062
Totals	**$8,501,820**	**$4,452,639**	**$4,049,181**		**$25,446,231**	**$36,432,803**

Two Project Owners Litigate Against The Department

These five projects were substantially rehabilitated under Section 881 of the Code of Federal Regulations. In the Spring of 1997, the Department reduced rents at Barbara Jordan I and Melrose Apartments to pre-conversion levels. The owners are currently in litigation with the Department. The owners of Barbara Jordan have taken the position that 42 U.S.C. Section 1437f(c) does not permit HUD to reduce the contract rents in effect on or after April 15, 1987 unless the project has been refinanced in a manner that reduces the periodic payments of the owner. A federal court judge issued a preliminary injunction restoring the rents to the post conversion levels at Barbara Jordan I. The Department disagrees with this position and is pursuing this litigation. As of March 31, 1998, neither case has been resolved.

Controls Over Improper Approval of Conversions

Discussion with Headquarters' Housing staff indicated that, in the past, controls were inherent in the regional structure which has since been dismantled under the reorganization. Since 1993, the Department has undergone several reorganizations and consolidations. Many of the Department's experienced State and Area office staff accepted buyouts taking with them vast institutional knowledge and program expertise that cannot be easily replaced.

At the same time, the Department is reorganizing by function and establishing new program Hubs. These ambitious reforms will take time to accomplish. Your staff anticipates that new controls will take effect when operations are shifted to the Kansas City Hub and the service centers. There is no way of knowing currently

how effective these prospective controls will be. While in this transitional mode, the Department needs to publicize the existing policy that converting any property's rental structure constitutes a waiver requiring the approval of an Assistant Secretary. While few in number, the conversions that have occurred have reserved millions of the Department's funds and are currently involving the Department in litigation.

In our draft report, we recommended that the Department implement a control system to prevent further improper conversions of rental structures. The Acting General Deputy Assistant Secretary felt that the conversions were so infrequent that no further control systems were necessary. He further stated that the offices responsible have been informed of their lack of authority. Based upon these assurances, we have removed our recommendation concerning additional controls from the final report.

Recommendation

We recommend that you:

1A. Publicize the Departmental policy and the requirements to be followed concerning any conversions.

Finding 2

HUD Needs To Ensure That Rents Do Not Substantially Exceed 120 Percent Of Fair Market Rents

The Department has approved rents at 54 budget-based projects at an average of 168 percent of the Fair Market Rents (FMRs). The Department is paying up to $17.1 million annually more to these projects than would be needed if rents were limited to 120 percent of FMRs. Analysis shows that some rent increases, in part, funded capital improvements contrary to Department policy. The Department needs promulgate adequate clarifications to limit high rents from being approved and funded in the future.

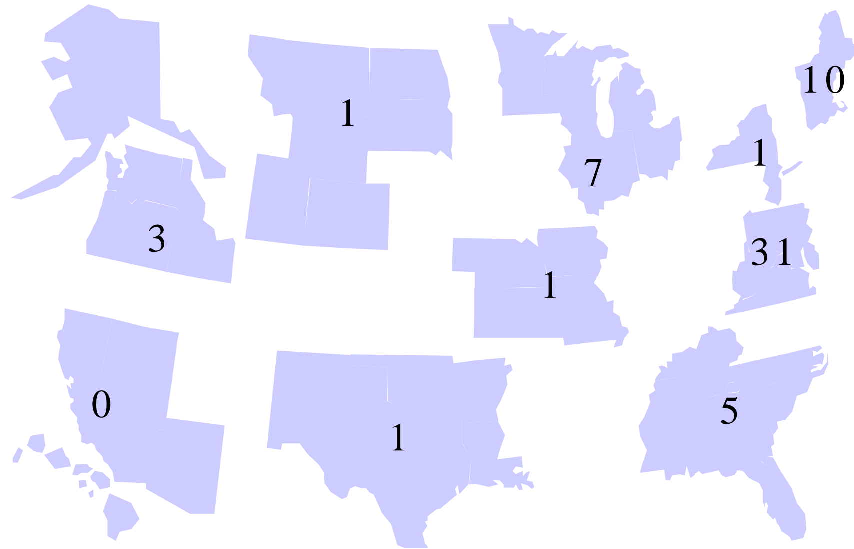
In the past, HUD's philosophy tried to minimize defaults on FHA-insured mortgages by, in many cases, increasing the cash flow through the use of higher Section 8 subsidies. For example, the primary goal of the Section 8 Loan Management Set-Aside Program was to reduce claims on the Department's insurance fund by aiding those FHA-insured projects having serious financial difficulties. This philosophy has led, in many cases, to higher and higher rents resulting in increased subsidies. As discussed in Finding 1, this philosophy led to the conversion of five projects from AAF rent structures to budget-based rent structures to provide for substantial increases in Section 8 subsidies for these projects. The conversions to budget-based subsidy allowed the State Offices to set rents at any level in accordance with the guidance in Handbook 4350.1 which states:

> *Be flexible, consider the needs of the project, the owner's return on investment and maintaining HUD's security interest. Keep in mind that both underestimating and over-estimating expenses can have undesirable impacts. If expenses are underestimated, deferred maintenance and defaults can result. If expenses are overestimated, the rents charged will be higher than needed which could result in HUD paying more subsidy than necessary.*

Directors of Housing Management have the authority to approve the operating budgets at any level they deem necessary while at the same time amending the Section 8 contracts to provide the whatever funding is required. We found no evidence of budget caps or other controls that would require additional or higher level reviews and appropriate approval process. We believe that HUD's responsibility in approving operating budgets under the prior philosophy coupled with a lack of controls to limit the availability of Section 8 funds for contract

amendments are the contributing causes for these 54 projects having rents far in excess of 120 percent of the FMRs.

Further analysis disclosed that sixty-eight percent of these projects were located in the New England and the Mid-Atlantic field offices. Details are contained in Appendix 2.



We learned, at one state office, that the rent increases were granted, in part, to fund capital improvements. Interviews with 51 Asset Management Branch Chiefs across the country found that 43 percent have granted rent increases to fund capital improvements since October 1, 1995. Increasing rents above FMRs to finance capital improvements is contrary to HUD policy as confirmed by:

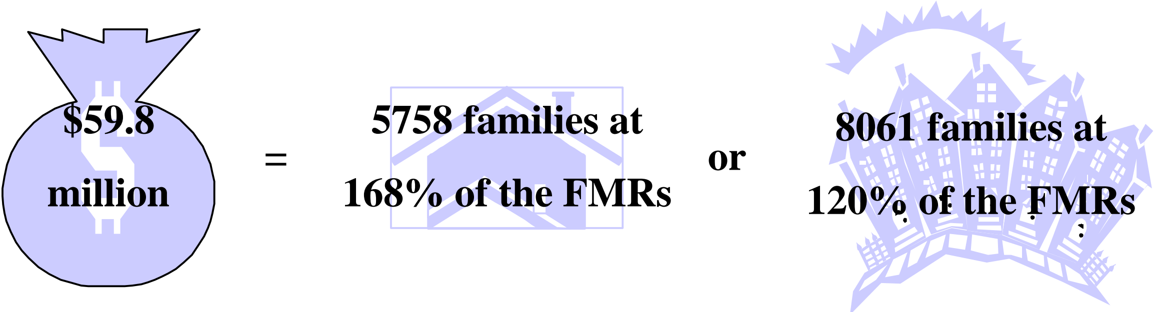
- A former Deputy Assistant Secretary for Multifamily Housing's March 22, 1995, memorandum to all Housing Directors that stated:

> *"There will be no Section 8 rent increases approved for capital improvements, except when the Field Office determines that rents are no higher than FMR. Where this results in continuation of unsafe conditions, your office should consider abatement and other steps to enforce Housing Quality Standards."*

- Another former Deputy Assistant Secretary for Multifamily Housing's May 9, 1997, letter to the Rhode Island Director of Multifamily that stated:

> *". . . It is not appropriate for your office to increase rents for repairs or rehabilitation that place the burden of paying for an owner's regulatory compliance on HUD."*

For the 54 projects identified, HUD is spending up to $59.8 million annually in rental subsidies in excess of 120 percent of FMRs to house 5,758 families for rents at an average of 168 percent of the FMRs. If these rents were at 120 percent of the FMRs, the Department could assist an additional 2,300 families.



Forty-nine of the 54 projects have had rents in excess of 120% of the FMRs since at least October 1, 1995.

Section of Act	Number Projects	Average % of FMRs	Annual $ over 120% of FMRs
Section 221	28	178%	$ 6,276,239
Section 236	19	168%	$ 8,516,144
Other	7	159%	$ 2,387,919
Total	**54**	**168%**	**$17,180,302**

We also note that approximately 60% of the HAP contracts at these 54 projects will expire before September 30, 1998.

Beginning in 1997, the Department has been reducing rents to 120 percent of FMRs upon renewal of Section 8 contracts. HUD's current interpretation of the laws governing Section 8 contracts is that projects insured under Section 236 are

specifically exempted from the requirement to reduce rents to 120 percent of the FMRs upon renewal. We were advised that this interpretation has not been subjected to an official Departmental legal opinion. As shown above, 19 of these projects are insured under Section 236 of the National Housing Act. Projects insured under Section 236 of the National Housing Act also receive an Interest Reduction Payment which reduces the effective interest rate on their mortgage to one percent. In 1997, HUD paid $4.4 million in Interest Reduction Payments on behalf of these projects. Considering the cost savings that might be achieved, the Department needs to revisit their interpretation regarding rent reductions for Section 236 projects upon renewal of the HAP contracts.

The Secretary said before the Appropriations Subcommittee on May 13, 1997, that HUD is recognizing its challenges at a time when the federal government has fewer and fewer resources. The FY 1998 HUD Appropriations Act establishes a transitional contract renewal policy for FY 1998 whose key provisions are to establish: (1) a cap of 120 percent of Fair Market Rents; (2) exemptions to the 120 percent FMR cap for public agency bond-financed, state-insured projects, rural housing service Section 515 projects, and Section 202 projects. HUD has the opportunity to reduce many of these contracts upon renewal.

HUD needs to promulgate policies to limit increases for budget-based projects for substantially exceeding 120 percent of the FMRs. Your staff expects to institute controls over rent increases at the new Kansas City Hub that is under development. The HUB is expected to begin operations by the close of this September 1998. In the interim, the Department needs to publicize what has happened and the ramifications of what has happened and promulgate policy to limit additional similar occurrences.

In our draft report, we recommended that the Department implement a control system to prevent high Section 8 rents from being approved in the future. The Acting General Deputy Assistant Secretary felt that once a policy clarification is promulgated, another level of control is not needed given the modest number of potentially excessive project rent approvals. Based upon this assurance, we have removed our recommendation for additional controls from the final report.

We have also withdrawn our draft recommendation that Housing revisit its exclusion of Section 236 projects from the requirements to reduce rents to 120 percent of FMRs upon renewal of the Section 8 HAP contract. Although Housing agreed to request further review of this exclusion by OGC, we are not controlling this item because we have made a request of OGC to review this matter.

Recommendation

We recommend that you:

2A. Publicize to all staff a consistent policy regarding granting rent increases for capital improvements including guidance concerning the maximum limits to which Section 8 rents can be raised.

Internal Controls

In planning and performing our audit, we considered internal controls in order to determine our audit procedures---not to provide assurance on the controls. Management is responsible for establishing effective controls. Internal control consists of plans, organization and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies. In each of these three categories, management will establish its own specific control objectives and procedures designed to achieve these objectives. If organizations are to meet these control objectives, five components of internal control must be present: control environment, risk assessment, control activities, information and communication and monitoring. Control objectives in each category are inextricably linked with the five supporting components. We obtained an understanding of management controls through inquiry, observation, and inspection of documents and records.

We determined that the following internal controls were relevant to our audit objectives:

- controls over rental subsidy conversions
- controls over granting Section 8 rent increases
- controls over approving rent increases for capital improvements

A significant weakness exists if internal controls do not give reasonable assurance that control objectives are met.

We found that five projects were converted to rental structures based on a budget by persons without proper authority which impeded the Department's ability to comply with Section 106 of the HUD Reform Act of 1989. In addition the Department has approved rents for 54 projects at levels which exceed 150 percent of FMRs and has granted rent increases for capital improvements. These matters are discussed in Findings 1 and 2 of this report.

Although these events evidence significant control weaknesses, the Acting General Deputy Assistant Secretary for Housing feels that, once Departmental policy is clarified and promulgated, there will be no need to improve the existing control systems.

Appendices

Appendix 1

Improper Approval Of Conversions At Five Properties

Five projects across the country were improperly approved for conversion from Annual Adjustment Factor (AAF) rent structures to budget-based rent structures.

Name	*Location*	*Date of Conversion*	*Pre-Conversion Rent*	*Post Conversion Rent*	*Maximum Annual Rents*
Barbara Jordan	Providence, RI	01/25/95	$2,292,315	$4,597,428	$4,505,760
Melrose Apts	Providence, RI	09/01/96	$ 342,384	$1,517,616	$1,517,616
SNAP I	Savannah, GA	04/05/94	$ 644,700	$ 778,668	$ 918,792
SNAP II	Savannah, GA	04/05/94	$ 553,464	$ 715,608	$ 830,292
Seven Oaks	Kansas City, MO	04/29/94	$ 376,704	$ 692,280	$ 729,360
Total			**$4,209,567**	**$8,301,600**	**$8,501,820**

Barbara Jordan Apartments

Barbara Jordan I Apartments is a 193-unit scattered-site project located in Providence, Rhode Island. It is owned by SPR Associates and has a mortgage insured under Section 223f of the National Housing Act of 1937 (NHA). Barbara Jordan I Apartments is 100% subsidized through Section 8 Contract RI43-A002-001 which expires on June 30, 2004. Rent levels for the past several years have been higher than Fair Market Rents (FMRs).

	1 bedroom		2 bedrooms		3 bedrooms		4 bedrooms	
Year	Rent	% FMR	Rent	% FMR	Rent	% FMR	Rent	% FMR
1994	850	155%	954	144%	1042	126%	1118	110%
1995	819	153%	1638	255%	2455	305%	3273	330%
1996	1675	311%	1878	290%	2046	252%	2192	219%
1997	1675	311%	1878	290%	2046	252%	2192	219%

HUD has had concerns about operations at this project for several years. An OIG audit (Report 91-BO-214-1003 issued in 1991) identified that the Management Agent diverted at least $606,485, paid unsupported costs in excess of $100,000 and failed to establish and maintain an acceptable financial management system. This report recommended removing the management agent and other administrative sanctions. While a decision was made not to remove the management agent because the diverted funds were repaid; other sanctions were taken such as a reduction in the amount of management fees. In 1992, a comprehensive management review identified that management was below average due to repeated problems related to the preventative maintenance, unit inspections, and procurement practices.

On December 23, 1994, the Director, Office of Multifamily at RISO sent a memorandum to the Deputy Assistant Secretary for Multifamily Housing Programs requesting approval to convert the rental structure from AAF to the budget-based approach. This memorandum stated the project was funded with proceeds from the sale of 11b bonds which generated $1 million for the physical repairs property when they were refunded on September 15, 1994. The real estate receives Section 8 rental assistance pursuant to 24 CFR Part 881 for all 193 dwelling units. The memorandum also identified that the real estate experiences abnormally high costs in operation which were not adequately compensated for by the current rent determination mechanism and is a defined troubled property. At the time of conversion, rents averaged 138% of the FMRs.

On January 25, 1995, the former Director, Office of Asset Management and Disposition in Washington, DC approved the conversion of the property from AAF to budget-based. His approval identified several conditions which were to be part of the HAP contract amendment. One condition was:

> *". . . The owner must agree that at the time of any HAP contract expiration/renewal:*
>
> > *. . . That the method of rent may be changed unilaterally by HUD and that the owner will abide by HUD's decision and required change at that time."*

The amendment to the HAP contract was dated January 1, 1995 and signed by the project owner and the Director of Multifamily Housing at the Rhode Island State Office. The amendment included the following language to cover the condition listed above:

> *". . . The Secretary may, at its discretion, or the PHA may with the Secretary's approval, adjust, revise, or change, the method upon which contract rent is calculated or adjusted provided that said adjustment, revision or change does not*

result in a reduction of contract rents approved beyond what is needed to pay project expenses (including debt service) and six per centum distribution to Owner . . . .”

A physical inspection of the property dated March 29, 1995 found the property to be *below average* for both physical condition and maintenance practices. The inspection identified over $750,000 of repairs--the majority for correcting violations of Housing Quality Standards. A physical inspection by the mortgagee on September 16, 1997 found the property to be in satisfactory condition.

On January 1, 1996, HUD increased the rents at Barbara Jordan I Apartments up to 311% of the FMRs by approving a budget of $4.5 million. As this contract does not expire until 2004, the owners could realize up to $17.5 million over and above 120 percent of FMRs through the end of the HAP contract.

In 1996, the Management Agent refused the RISO access to the records of his Identity of Interest (IOI) companies. The RISO had concerns that the payments to the IOI companies did not reflect actual costs, but included excessive markups contributing to the poor cash flow. According to the audited financial statements, over $2 million was paid to IOI companies

On May 16, 1997, the RISO attempted to reduce rents to:

1 bedroom		2 bedrooms		3 bedrooms		4 bedrooms	
RENT	% FMR	RENT	% FMR	RENT	% FMR	RENT	% FMR
921	171%	1031	159%	1122	138%	1203	120%

In December 1997, the project owners’ obtained a preliminary injunction preventing HUD from reducing rents based on 42 CFR 1437f (c) (2) (C) which advises that contract rents will not be reduced for Substantial Rehab projects. HUD disagrees and is contesting that decision.

In July 1997, there were two releases from the reserve for replacement to pay utility costs of over $125,000 to prevent the utility companies from suspending service. The Reserve for Replacements is generally used to help defray the costs of replacing a project’s capital items. Utilities are not considered capital items. Between February 21, 1995 and July 25, 1997, over $1.4 million was withdrawn for plumbing repairs, lead abatement to the water supply, utilities and legal expenses.

Melrose Apartments

Melrose Apartments is a 42-unit scattered-site property located in Providence, RI and is insured under Section 221d of the NHA. It is owned by Melrose Associates, a partnership whose partners have been disputing for several years. Melrose Apartments is 100% subsidized through Section 8 Contract RI43-A002-001 which expires on September 25, 2003.

A physical inspection dated July 15, 1996 stated the property was in *below average* condition and needs over $475,000 in repairs. It also stated that many of these repairs had been previously reported and preventive maintenance was not timely. A physical inspection by the mortgagee on September 18, 1997 found the property to be in below average condition.

On November 7, 1996, the rent structure at Melrose Apartments was converted from an AAF basis to an operating budget basis retroactive to September 1, 1996. This conversion was not approved in accordance with the laws and regulations governing the Department. As a result of this conversion, the maximum contract rental potential increased by $1.1 million. The majority of the rent increase was to fund exterior repairs.

As seen in the table below, rents were approved at rates which exceeded FMRs by as much as 508%. The RISO determined revised rent levels by raising rents to whatever amount was necessary to fund budgeted items regardless of its relation to FMRs.

	1 bedroom		2 bedrooms		3 bedrooms	
Year	Rent	% FMR	Rent	% FMR	Rent	% FMR
1995	610/617	155%/157%	674/703	126%/132%	741	115%
1996	2704/2735	503%/508%	2988/3116	462%/482%	3285	405%
1997	2704/2735	503%/508%	2988/3116	462%/482%	3285	405%

The OIG reported by memorandum (97-BO-111-0805 issued June 25, 1997) that controls had not been adequately established by the RISO and over $500,000 in repair funds could not be accounted for. As a result of the OIG Audit and Special Workout Assistance Team involvement, rents were reduced to pre-conversion levels on June 1, 1997. This action is currently the subject of a lawsuit by the project owners.

SNAP I & II

Savannah Neighborhood Action Plan I (alias SNAP I) and Savannah Neighborhood Action Plan II (alias SNAP II) consist of 189 units on 52 scattered sites located in the historic district of Savannah. The projects are insured under Section 221d(4) of the NHA. Pursuant to HAP contracts with effective dates of

February 1, 1983 and November 9, 1983 respectively, all of the units at SNAP I and SNAP II receive Section 8 assistance under part 881 of the CFRs.

On January 31, 1994, the Director of Housing at the Georgia State Office (GSO) requested approval of the conversion of the rental adjustment mechanism at SNAP I and SNAP II from the AAF to a budget-based approach. The Director of Housing for the GSO stated that:

> *"I am confident that conversion to the budget-based method is the only solution to the serious problems associated with these project."*

The Director of Housing indicated that such a conversion was necessary to preserve the mortgaged premises and to satisfy regular debt service and explained that:

> *". . .the deferred maintenance of the projects is not the fault of the owner. Management has kept the property as well maintained as the operating funds would allow. The problem appears to be due in part to low projected expenses during the original loan processing and low rental adjustment factor over the years."*

The Director of Housing also indicated that the location of the property in a historic district limited the owner's options to change the structure of the buildings or reduce the cost of maintenance through the installation of vinyl siding.

The Director of Housing held the owners blameless without explaining 1) whether there were substantial increases in these expenses or 2) whether the owner could control or influence the amount or timing of such increases. Handbook 4350.1 Multifamily Asset Management and Project Servicing Chapter 7-29 (G) (2) instructs the Field office to assess whether the actual expense base is reasonable for the level maintenance expected during the next year and whether the project is taking reasonable efforts to control costs

The Director of Housing indicated that if a solution to the repair funding was not found, the Director of Housing would be forced to abate Section 8 payments resulting in a claim against the insurance fund.

On April 5, 1994, the Director approved the Georgia State Office's request and stated:

> *"Based on our review of the documentation submitted, we have made a determination to convert the rent increase process for SNAP I and SNAP II from the use of the annual adjustment factor to the budget approach. We are approving the conversion for the following reasons:*
>
> - *Your office recommended this Section 221 (d)(4) Substantial Rehab project because it preserves necessary and affordable housing for the community.*
> - *The properties are located on 52 scattered sites in a historic district which limits the owner's ability to change the structure of the wood-framed buildings.*
> - *Attempts by the owner to obtain funding are not sufficient to provide for the long term viability of the project.*
> - *Approval of this conversion will help make this project financially viable.*
>
> *Budget-based rent increases are to be based on reasonable and supportable project expenses for project operations, debt service and a return on the owner's investment.."*

Approval of the conversions from AAF to budget-based and subsequent rent increases have raised rents as a percentage of the FMRs to as high as 174 percent at SNAP I…

	Efficiency		1 bedroom		2 bedrooms		3 bedrooms		4 bedrooms	
Year	Rent	% FMR	Rent	% FMR	Rent	% FMR	Rent	% FMR	Rent	% FMR
1993	435	127%	460	108%	504	101%	621	109%	654	94%
1994	525	153%	556	130%	609	122%	751	132%	790	113%
1995	525	153%	556	130%	609	122%	751	132%	790	113%
1996	525	151%	556	129%	609	122%	751	111%	790	113%
1997	525	151%	556	129%	609	121%	751	111%	790	113%
1998	620	174%	656	149%	718	140%	886	128%	932	129%

. . . and up to 185% at SNAP II.

Year	Efficiency		1 bedroom		2 bedrooms		3 bedrooms		4 bedrooms	
	Rent	% FMR	Rent	% FMR	Rent	% FMR	Rent	% FMR	Rent	% FMR
1993	440	131%	442	106%	477	98%	598	91%	615	90%
1994	569	169%	572	137%	617	127%	772	118%	795	117%
1995	569	164%	572	133%	617	124%	772	114%	795	113%
1996	569	164%	572	133%	617	123%	772	114%	795	113%
1997	569	145%	572	107%	617	96%	772	96%	795	80%
1998	660	185%	666	151%	716	139%	896	129%	922	128%

In September 1995, a physical inspection by the Department found both SNAP properties to be in "below average" condition with leaky roofs, corroded fire escapes, deteriorating exterior wood siding, broken windows, and infestation. A management review of the SNAP properties conducted in April 1996 found the management operations to be "satisfactory" with improvements needed in physical condition and cost controls. The management review stated that the physical condition and cost controls are done, in part, to the Victorian architecture and the location of the property in a historic district which precludes many cost containment measures. The type of construction and high maintenance expenses are only exacerbated by the humid climate. In April 1997, a physical inspection of SNAP, I found the project to have improved to satisfactory condition.

Seven Oaks

Seven Oaks consists of 78 units located in a depressed neighborhood of Kansas City, MO. The project is insured under Section 221d(4) and was built in 1971. Pursuant to a HAP contract effective October 29, 1980, all units receive Section 8 assistance under part 881 of the CFR.

In 1994, the Kansas State Office requested approval to convert Seven Oaks from an AAF basis to an operating budget basis as inferred by the approval granted April 29, 1994. Documentation of the request could not be located. An undated and unsigned internal memorandum from the Acting Director, Office of Housing , Kansas State Office to the Deputy Assistant Secretary for Multifamily Housing Programs and the Director of Office of Multifamily Housing Management states that the project could not generate enough cash flow under the AAF rent structure to handle the maintenance required at the property. This memorandum also stated that, as a result, there was over $500,000 in deferred maintenance in 1991.

On April 29, 1994, the Director of Office of Multifamily Housing Management approved the conversion. The approval memorandum stated:

> *"As the owner is reportedly unable to rectify the physical problems and maintain fully funded operations, this action appears to be the only present alternative available to protect the residents. . . .We note the owner has not paid the mortgage and there is a danger of assignment."*

The approval was conditioned on three requirements: 1) modifications to the HAP and the Regulatory Agreement to reduce the distribution levels, 2) agreement to forfeit incentives for renewal, enter a renewal offered by HUD and permit HUD to change the method of rent unilaterally, and 3) modification of the HAP contract to allow HUD for alternative enforcement provisions in the contract as they are developed.

Approval of the conversion from AAF to budget-based has increased the rents and the rents as a percentage of the FMRs at the Seven Oaks to as high as 229 percent:

	1 bedroom		2 bedrooms		3 bedrooms	
Year	Rent	% FMR	Rent	% FMR	Rent	% FMR
1993	414	144%	454	123%	487	100%
1994	651	226%	714	193%	765	157%
1995	651	226%	714	193%	765	157%
1996	686	233%	752	199%	806	169%
1997	686	229%	752	195%	806	163%

In October 1997, a physical inspection by the mortgagee found the property to be in *"below average"* condition with broken outer doors, and vandalized vacant units. A management review conducted in December 1996 found the management operations to be "below average" because of the continuing physical problems due to vandalism and drug-related crime.

Appendix 2

Fifty-four Budget-based Projects With Rents In Excess Of 120% Of The Fair Market Rents						
	Name	**Office**	**Percent of FMRs**	**Maximum Annual Rent Potential**	**If rents are set to 120% of FMRs**	**Difference**
1	1890 House	Providence	146%	$ 434,100	$ 357,869	$ 76,231
2	Evergreen	Providence	150%	$1,904,664	$ 1,523,318	$ 381,346
3	Riverbend	Providence	150%	$ 1,954,980	$ 1,563,581	$ 391,399
4	Roger & Roger	Providence	217%	$ 402,984	$ 222,451	$ 180,533
5	Vulcan Assoc I	Providence	171%	$ 488,784	$ 343,224	$ 145,560
6	Chatham Village	Providence	222%	$ 713,424	$ 385,488	$ 327,936
7	Huntington	Providence	239%	$ 1,373,147	$ 690,336	$ 682,811
8	Maple Knoll	Manchester	152%	$ 303,240	$ 240,163	$ 63,077
9	Taino Towers	New York	161%	$10,740,696	$ 7,985,002	$ 2,755,694
10	Bethome	Pittsburgh	147%	$ 599,976	$ 490,738	$ 109,238
11	Brymard Apts.	Pittsburgh	191%	$ 259,344	$ 163,296	$ 96,048
12	East Mall	Pittsburgh	185%	$ 1,306,216	$ 849,254	$ 456,962
13	Greenway Park	Pittsburgh	161%	$ 746,064	$ 554,386	$ 191,678
14	MonView Hts.	Pittsburgh	158%	$ 3,032,472	$ 2,298,211	$ 734,261
15	Palisades	Pittsburgh	173%	$ 458,400	$ 317,952	$ 140,448
16	Penn Circle	Pittsburgh	175%	$ 1,236,900	$ 849,254	$ 387,646
17	Second East	Pittsburgh	151%	$ 3,029,076	$ 2,413,642	$ 615,434
18	Hill Com II	Pittsburgh	167%	$ 437,664	$ 314,899	$ 122,765
19	Homewood	Pittsburgh	182%	$ 1,329,024	$ 876,226	$ 452,796
20	Just Inn	Pittsburgh	236%	$ 388,040	$ 197,237	$ 190,803
21	Leo Meyer	Pittsburgh	191%	$ 330,768	$ 207,346	$ 123,422
22	St. Mary Mercy	Pittsburgh	219%	$ 313,440	$ 172,051	$ 141,389
23	State Manor	Pittsburgh	150%	$ 746,796	$ 598,003	$ 148,793
24	TowneTowers	Pittsburgh	227%	$ 614,376	$ 325,037	$ 289,339
25	Valley Terrace	Pittsburgh	200%	$ 1,814,592	$ 1,089,792	$ 724,800
26	Terry Apts	Philadelphia	177%	$ 1,631,412	$ 1,107,518	$ 523,894
27	Quaker Hill	Philadelphia	175%	$ 1,737,960	$ 1,194,192	$ 543,768
28	Montgomery	Philadelphia	206%	$ 1,918,152	$ 1,118,131	$ 800,021
29	Chester Apts.	Philadelphia	158%	$ 1,342,176	$ 1,016,381	$ 325,795
30	Timberland Apts.	Philadelphia	163%	$ 847,884	$ 623,304	$ 224,580
31	Cobbs Creek	Philadelphia	169%	$ 1,237,740	$ 878,832	$ 358,908
32	York NSA	Philadelphia	189%	$ 841,452	$ 532,886	$ 308,566

Fifty-four Budget-based Projects With Rents In Excess Of 120% Of The Fair Market Rents						
	Name	**Office**	**Percent of FMRs**	**Maximum Annual Rent Potential**	**If rents are set to 120% of FMRs**	**Difference**
33	Strawberry	Philadelphia	151%	$ 476,856	$ 380,160	$ 96,696
34	Finch Towers	Philadelphia	296%	$ 520,704	$ 211,277	$ 309,427
35	Freeland Elderly	Philadelphia	222%	$ 411,444	$ 222,581	$ 188,863
36	Hockindauqua	Philadelphia	168%	$ 351,648	$ 250,906	$ 100,742
37	Haverford	Philadelphia	173%	$ 338,904	$ 235,238	$ 103,666
38	Baynton Manor	Philadelphia	168%	$ 154,608	$ 110,678	$ 43,930
39	Coplay Apts.	Philadelphia	158%	$ 99,960	$ 76,032	$ 23,928
40	Park Regency	Louisville	163%	$ 249,120	$ 182,995	$ 66,125
41	St Andrew	Jacksonville	156%	$1,728,864	$ 1,329,696	$ 399,168
42	Livermore	Louisville	159%	$ 336,000	$ 252,979	$ 83,021
43	Pin Oak	Chicago	198%	$ 97,200	$ 58,867	$ 38,333
44	Ridgewood Hills	Cincinnati	158%	$3,684,936	$ 2,796,034	$ 888,902
45	Regency Square	Cleveland	183%	$ 815,220	$ 533,434	$ 281,786
46	Carter Manor	Cleveland	171%	$2,460,060	$ 1,723,493	$ 736,567
47	Phillis Wheatley	Cleveland	155%	$ 382,032	$ 296,150	$ 85,882
48	Belvidere	Cleveland	150%	$ 167,760	$ 134,136	$ 33,624
49	Villa Maria	Grand Rapids	162%	$1,662,876	$ 1,231,877	$ 430,999
50	Prince Hall	Houston	150%	$ 918,528	$ 776,333	$ 142,195
51	Dakota Estates	Denver	200%	$ 48,060	$ 28,901	$ 19,159
52	Down Manor	Portland	161%	$ 147,120	$ 109,440	$ 37,680
53	Stayton Manor	Portland	156%	$ 118,176	$ 91,008	$ 27,168
54	Hazel Court	Portland	155%	$ 117,504	$ 91,008	$ 26,496
	TOTALS		**168%**	**$59,803,523**	**$42,623,223**	**$17,180,298**

Appendix 3

Auditee Comments

Appendix 4

Distribution

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The Honorable Fred Thompson, Chairman, Committee on Governmental Affairs, United States Senate, Washington, DC 20510-6250 (1)

The Honorable John Glenn, Ranking Member, Committee on Governmental Affairs, United States Senate, Washington, DC 20510-6250 (1)