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Audit-Related Memorandum  
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MEMORANDUM FOR: Nicolas Retsinas, Assistant Secretary for Housing  
Federal Housing Commissioner, H

FROM: Gary E. Albright, District Inspector General for  
Audit, 9AGA

SUBJECT: Review of Section 223(f) Refinancing  
Country Village Apartments, Project No. 143-11012  
Riverside, California

#### INTRODUCTION

As you requested, we reviewed the HUD Los Angeles Area Office's (LAAO) processing of Section 223(f) refinancing of Country Village Apartments. Our objectives were to: (1) evaluate whether LAAO followed HUD procedures when processing the Section 223(f) refinancing sought by the owner, and (2) determine whether HUD's processing procedures were adequate to protect HUD's interest and, if not, whether further guidance to HUD field offices is needed.

#### SUMMARY

We concluded that LAAO did not complete all specified processing procedures for approving the Section 223(f) loan; however, LAAO's deviations from HUD requirements did not result in any material adverse impact on HUD or other program participants. Although HUD Headquarters requested that LAAO expedite the processing of Country Village's application, LAAO received no instructions from HUD Headquarters to skip any processing procedures. Based on the results of our review, we believe that HUD procedures for processing Section 223(f) loan applications are adequate to protect HUD's interest; therefore, additional guidance to HUD field offices is not needed.

The Deputy Assistant Secretary for Multifamily Housing Programs (DAS) recently determined that the owner of Country Village Apartments had violated the Regulatory Agreement. As a result the DAS imposed enforcement actions requiring the owner to install new professional

property management, develop a Capital Needs Assessment, and stop any distribution of project income for nonconversion payments, except from surplus cash as defined by the Regulatory Agreement. Based on the results of our review we strongly endorse those enforcement actions.

## BACKGROUND

Country Village Apartments is a 1,194 unit project located in Riverside County, 50 miles east of Los Angeles, California. The project consists of 89 buildings along with amenities such as a nine-hole golf course, restaurant, market/liquor store, laundromats, arts and crafts facilities, and more. The original Section 231 (Elderly Housing) mortgage note for \$11,788,400 was dated April 1, 1965. After the original owners defaulted, Mira Loma Associates (owner), a limited partnership, acquired the project and entered into a Regulatory Agreement with HUD on December 9, 1968. In 1983, HUD sold the Secretary-held mortgage and insured a new \$9,618,643 mortgage under Section 207 pursuant to Section 223(c) of the National Housing Act. The project is unsubsidized except for 123 tenants receiving tenant-based Section 8 housing assistance from the Housing Authority of the County of Riverside.

After receiving a \$25 million purchase offer in 1979, Mira Loma Associates tried to convert the units into condominiums and sell the project. The Riverside County Board of Supervisors (Board), however, denied the conversion request because the project did not meet the County's requirements for conversion. The streets were not wide enough, there were insufficient parking spaces per unit, and about one-third of the units were too small for use as condominiums. The owner, however, appealed the Board's denial of the request for condominium conversion.

Concern for the owner's threat to convert the project to condominiums caused the tenants to form a non-profit corporation, Country Village Inc. (CVI) and, beginning in 1982, CVI leased the project in its entirety from Mira Loma Associates. CVI subleased the units to the tenants who became part of the tenant corporation. Under the lease agreement CVI was to pay the owner an amount that was essentially equal to the mortgage payment, insurance, and taxes. CVI also had to pay all operating costs and make payments to the owner under a Nonconversion Agreement.

The twenty-year Nonconversion Agreement with Mira Loma Associates required CVI to pay the owner an escalating amount that was initially paid from a monthly assessment of the tenants, but later it became a part of each tenant's rent. Although the County of Riverside denied the owner's request to convert the project into condominiums CVI agreed

to pay for the Nonconversion Agreement because it feared that the owner's appeal might somehow eventually get approved. HUD consented to the lease and was aware of the Nonconversion Agreement. On July 30, 1993 the owner submitted an application to LAAO for refinancing of Country Village under Section 223(f). LAAO screened the application; however, it rejected the application on September 20, 1993 because it was incomplete. After a subsequent meeting with the owner LAAO sent a letter explaining that the initial screening of the application had been delayed due to the volume of work, competing priorities, and insufficient staffing. The letter further stated that upon receipt of an acceptable application, the processing of just the conditional commitment would take approximately 120 days.

Because of the forecast delay, the owner contacted the Deputy Assistant Secretary for Multifamily Housing Programs (DAS) and requested that the application be given expedited processing. In return, the owner claimed it would extend the Nonconversion Agreement with the tenants for an additional 20 years. The owner told HUD that if the processing of the loan application was not expedited it would refinance the mortgage elsewhere, thereby ending the tenants' protection against condominium conversion. The DAS instructed LAAO's Director of Development to give the application top priority. To speed up the process LAAO's Director of Development decided that the processing would be done in-house instead of by the normal delegated processor. HUD issued the firm commitment for insurance on December 15, 1993 and a new loan of \$28,256,700 was finally endorsed on March 22, 1994. After paying off the original mortgage the owner took out a cash equity of about \$19 million.

Since the refinancing of the mortgage loan, HUD staff members visited Country Village to review the project's operations. Their review disclosed that inadequate management of the project had caused various violations of the Regulatory Agreement. HUD also said that the nonconversion payments could be considered a distribution rather than a necessary project expense. In a September 11, 1995 letter HUD requested the owner to correct the violations, terminate the management agent, develop a Capital Needs Assessment, and perform a Reserve for Replacement analysis.

In October 1995 the DAS took certain enforcement actions against Country Village. HUD terminated its approval of the identity-of-interest management agent, Midwest Investment Corporation, and approved Porta Management Group as new agent effective in November 1995. HUD also instructed CVI not to make further nonconversion payments

from project funds, except out of surplus cash as defined by the Regulatory Agreement.

## OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to: (1) evaluate whether LAAO followed HUD procedures when processing the Section 223(f) refinancing of Country Village Apartments, and (2) determine whether HUD's processing procedures were adequate to protect HUD's interest and, if not, whether further guidance to HUD field offices is needed.

To accomplish our objectives, we interviewed HUD Headquarter's and LAAO officials, reviewed appropriate HUD handbooks and regulations, reviewed HUD LAAO files, and inspected the project's units and buildings.

The review generally covered the period January 1993 through December 1994. We performed the field work between October and November 1995.

## RESULTS OF REVIEW

LAAO did not complete all processing procedures for approving the Section 223(f) loan; however, LAAO's deviations from HUD requirements did not result in any material adverse impact on HUD or other program participants. Although HUD Headquarters requested that LAAO expedite the processing of Country Village's loan refinancing application, it did not indicate that the LAAO was expected to skip any processing procedures. Further, based on the results of our review, we believe that HUD procedures for processing Section 223(f) loans are adequate to protect HUD's interest; therefore, additional guidance to HUD field offices is not needed.

The Deputy Assistant Secretary for Multifamily Housing Program's (DAS) recently determined that the owner of Country Village Apartments had violated the Regulatory Agreement. As a result the DAS imposed enforcement actions requiring the owner to install new professional property management, develop a Capital Needs Assessment, and stop any distribution of project income for nonconversion payments, except from surplus cash as defined by the Regulatory Agreement. Based on the results of our review we strongly endorse those enforcement actions.

LAAO's estimate of Country Village's fair market value was accurately determined. This, in turn, allowed HUD to properly establish a limitation on the maximum loan amount.

Details of the results of our audit work are discussed below:

a. LAAO's Processing of Country Village's Section 223(f) Refinancing Loan

LAAO deviated from HUD processing requirements by not fully completing all the required processing procedures. Specifically, LAAO did not: (1) follow its normal work pattern but instead, expedited the loan processing of Country Village ahead of other loan applications; (2) use market rents to determine the maximum insurable mortgage; (3) inspect 100% of the units in order to identify needed repairs; and (4) require the owner to make the required amount of initial deposit into the Reserve for Replacement (R & R) Account.

LAAO Expedited Loan Processing.

After LAAO notified the owner that the timetable for completion of the processing of the application for refinancing would be affected by staff availability and workload, the owner requested HUD Headquarter's help to expedite the processing. The owner told HUD officials that if the processing was not expedited, it would refinance the mortgage elsewhere, thereby, ending the nonconversion agreement with the tenants.

The DAS requested that LAAO give the Country Village 223(f) loan application top priority. We did not find any evidence that the DAS instructed LAAO to skip any processing procedures; however, LAAO's Director of Development decided it was necessary to process the application in-house instead of using a delegated processor in order to ensure that the requested priority was given. Expediting Country Village's processing may have resulted in some delays in completing the processing of other projects' loan applications, but none were withdrawn or otherwise adversely affected. Also, LAAO officials involved with the processing believed that Country Village did not receive anything that it would not have received if the processing had taken a normal course.

LAAO Used Lower Than Market Rents When Determining The Maximum Insurable Mortgage.

To expedite the processing of Country Village's loan application, LAAO calculated the maximum insurable mortgage amount by using the project's actual rents rather than using market rents. Paragraph 5-6 of HUD Handbook 4565.1 specifies that market rents

should be used for determining the maximum insurable mortgage. Since the actual rents at Country Village were estimated to be about 30 to 35 percent lower than market, their use allowed the maximum insurable mortgage to be set lower than it otherwise could have been. As a result HUD's exposure in the event of a default was diminished by LAAO's deviation from the processing requirements.

The mortgage amount of \$28,256,400 resulted from using the lower actual rents for the calculations. In October 1995, our OIG appraiser determined that Country Village's rents were about 18 percent lower than market rents, even after Country Village had raised its rents by about 8 percent in September 1994.

#### LAAO Did Not Inspect the Required Number of Units.

In order to expedite the completion of Country Village's 223(f) loan processing, the LAAO Architect/Engineer inspected only 10 percent of the 1,194 units instead of 100 percent, as required by HUD Handbook 4565.1. HUD's processing procedures require that for multifamily projects that are over 10 years old, all units must be inspected in order to identify any needed repairs that would be required to bring the property up to a marketable state. LAAO's Director of Development, however, instructed the Architect to only inspect a random sample of 10 percent in order to complete the inspections in just one week, and to expand the inspection only if the results warranted. The Architect's inspections found that no repairs were needed for any of the 120 units inspected.

Subsequently, a HUD contractor, ACRC, Inc., also inspected 238 of the 1,194 units (20 percent) on February 15, 1995. At that time ACRC identified needed repairs totaling \$95,000; \$72,000 of this was for needed carpeting and painting. If we assume that the other 80 percent of the units were in similar condition, we estimate that needed repairs of about \$475,000 could be expected. Our OIG inspector also inspected vacant units in October 1995 and determined that the project's units needed only minor maintenance which had been deferred since HUD approved refinancing of the loan in March 1994.

Based on the results of the ACRC inspection and that of our OIG inspector we believe that the 10 percent inspection accurately portrayed the condition of the project's units at the time the project was refinanced. Accordingly, there was no adverse effect from the LAAO's decision not to follow HUD's processing requirements in this area.

## The Initial Deposit to the Reserve for Replacement (R & R) Account Was Substantially Less Than Required.

HUD procedures allow two methods to determine the initial deposit into the Reserve for Replacement Account for Section 223(f) refinancing. One is to calculate the deposit based upon a formula and the second is to complete a physical take off of the items to be considered in the replacement reserve.

In order to expedite the loan processing, LAAO used the first method to calculate the initial deposit to the R & R. HUD Handbooks 4565.1 and 4465.01 allow HUD to calculate the initial deposit by multiplying the dollar amount of total structures by .004 and multiplying that result by the age of the project, not to exceed 15 years. For Country Village, the result was \$2,672,940; however, the Director of Development required the owners to deposit only \$267,625, or approximately 10 percent of that required. LAAO's Director of Development said that he had no recollection as to why the amount of the initial deposit was only 10% of the required amount. The LAAO Appraiser also did not know why this was done, but speculated that the smaller amount may have been justified because LAAO's physical inspection of the units did not identify any needed repairs.

This determination has not, as yet, had any adverse effect on HUD; however, the R & R may be seriously underfunded. HUD has recently required the owner of Country Village Apartments to develop a Capital Needs Assessment (CNA). We believe that HUD should evaluate the results of this assessment and require the owner to adjust the R & R balance in order to fully cover anticipated project needs.

### b. Additional Guidance To Other Field Offices Is Not Needed

We believe that the deviations taken by LAAO during the processing of Country Village's refinancing do not indicate a need for additional guidance. HUD's current procedures for evaluating and approving Section 223(f) refinancing applications are adequate to protect HUD's interest if those procedures are followed.

The financial and management problems that have surfaced at Country Village Apartments since HUD approved the refinancing do not appear to be related to the deviations taken by the LAAO staff during the processing. Instead, they appear to be attributable to the nonconversion agreement payments that were being paid out of project

funds rather than from surplus cash, decreasing revenues due to vacancy losses, and unresolved deferred maintenance.

c. Recent Enforcement Actions By HUD

In October 1995, the Deputy Assistant Secretary for Multifamily Housing Programs determined that the owner of Country Village Apartments was in violation of the Regulatory Agreement and issued an enforcement letter to the owners requiring the following actions:

1. Identify and install a new professional management agent to manage the project;
2. Provide a detailed plan and schedule for correction of management problems identified by HUD;
3. Stop making distribution of project's income in the form of nonconversion payments except from surplus cash;
4. Submit year-to-date audited financial statements;
5. Develop a Capital Needs Assessment and a schedule for its implementation; and
6. Keep the rental status of the project for the first five years while the project's mortgage is insured by HUD, pursuant to Section 223(f) of the National Housing Act.

Based on our review, we believe that the above enforcement actions taken by HUD are warranted and necessary to improve the management of Country Village Apartments.

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Please call Glenn Warner, Assistant District Inspector General for Audit, at (415) 436-8101 if you have any questions.