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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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The Honorable Daniel J. Flood
House of Representatives

Dear Mr. Flood:

HUD

In accordance with your June 24, 1975, request and the agreement reached with your office on July 24, 1975, we examined operations of two ~~Department of Housing and Urban Development~~ supported housing projects in Pennsylvania--Sheridan Manor in Wilkes-Barre and Hanover Village in Hanover Township. We confined our review to the following matters.

- Identifying reasons for the increases in operating costs which resulted in requests for rental increases and verifying the validity of these reasons.
- Determining tenants' rights to participate in the management and decisionmaking process affecting requests for rental increases according to Federal, State, and local laws and regulations.
- Examining the law and Department guidelines and regulations to determine if identity of interests are allowed between project mortgagees, sponsors, builders, and managing agents.

We examined records and talked to officials at Department regional and area offices in Philadelphia, Pennsylvania, at Department headquarters in Washington, D. C., and at the two projects. Additional information was obtained from representatives of the projects' tenants action committee and local legal and housing authorities in Pennsylvania.

We found that:

- The latest Department-approved monthly rental increases at both projects were precipitated primarily by increases in operating expenses, particularly in such areas as taxes and utilities. In our opinion, the average monthly increases were excessive in the amounts of \$2.09 at Sheridan Manor and \$8.48 at Hanover Village. The Department agreed that the rental increases were excessive and requested certified

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financial statements as of December 31, 1975, from each project before deciding on the propriety of rent rollbacks retroactive to the date of the rental increases.

- In accordance with Department regulations, proposed rental increases were posted at both projects at least 30 days before each proposal was submitted to the Department. This afforded the tenants the opportunity to comment on the increases to both the Department and project sponsors. No other rights for participating in decisions on rental increases are provided to tenants by existing Federal, State, or local laws or by Department regulations.
- Identity of interest between the project sponsor and construction contractor during construction and between the sponsor and managing agent at the time of our review existed for both projects. However, Federal law and Department regulations do not prevent such relationships but require that they be disclosed to the Department, as was the case for both projects.

BACKGROUND

Sheridan Manor

Sheridan Manor is a 200-unit apartment complex in Wilkes-Barre, Pennsylvania. Constructed at a cost of about \$3.2 million, the project accepted its first tenants in October 1971. Sheridan Manor is currently owned by a partnership of three individuals who acquired initial interest in the property in late 1970. One of the owners is also the managing agent.

Sheridan Manor is insured by the Department under section 236 of the National Housing Act (12 U.S.C. 1715z-1). This section of the act authorized a program to insure privately financed mortgage loans for constructing or rehabilitating multifamily housing projects for low- and moderate-income families and to pay, on behalf of the mortgagors, the mortgage insurance premiums and the interest on the mortgage loans over 1 percent. Because the Department makes these payments--called interest reduction payments--a basic monthly rent for each housing unit is established at a lower rate than would apply if the project received no Federal assistance. Interest reduction payments made by the Department for this project totaled \$172,986 in calendar year 1975.

Section 236 provides that a tenant pay either the basic rent or 25 percent of his monthly income, whichever is greater, and that a tenant's rent payment not exceed the fair market rent. The rent

supplement program, similar to that described in the section on Hanover Village which follows, is also available to section 236 projects such as Sheridan Manor. The Sheridan owners, however, have chosen not to participate in this program, and therefore none of their tenants receives rent supplement assistance.

Incentives to invest in federally subsidized multifamily housing have been provided by the law covering section 236 projects which permits owners to receive a 6-percent return on their investment and tax shelters, such as accelerated depreciation, that may reduce Federal income tax liability. However, Sheridan Manor owners have not realized a return on investment since the inception of the project due to operating losses. Losses reported in certified financial statements for calendar years 1973 and 1974 amounted to \$118,444 and \$140,958, respectively.

The average monthly basic rental rate per Sheridan Manor apartment has increased from \$121.63 in October 1971 to \$153.43 in July 1975.

Hanover Village

The Hanover Village apartment complex is made up of 151 rental units located in Hanover Township, Pennsylvania. Constructed at a cost of about \$2.8 million, the project began accepting tenants in November 1972. Hanover Village is owned by a partnership of 5 general and 10 limited partners and is managed by a firm owned by two of the Hanover Village general partners. The current owners acquired their initial interest in the property in December 1973.

Hanover Village is insured by the Department under the "market rate" segment of section 221(d)(3) of the National Housing Act (12 U.S.C. 1715(1)). Designed to provide housing for low- and moderate-income and displaced families, the market rate segment of the section 221(d)(3) program does not subsidize mortgage interest payments and mortgage insurance premiums. However, the program does provide certain inducements to sponsors, including the same tax advantages afforded section 236 projects and a possible 6-percent annual return on the owner's investment. According to certified financial statements, operating losses were incurred of \$101,470 in calendar year 1973 and of \$86,731 in 1974. These losses precluded the Hanover Village owners' realizing any return on their investment.

The Department is also authorized to subsidize the rents charged qualified tenants in section 221(d)(3) projects. In exchange for rent supplement assistance, the project owner agrees to obtain Department

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approval for all rent changes. Within established limitations, the rent supplement is generally the difference between 25 percent of the tenant's adjusted income and the market rent, which is determined by considering operating costs, amortization of the mortgage, the mortgage insurance premium, allowance for vacant units, and the Department-approved allowance for profit on the owners' investment.

A tenant in a project such as Hanover Village is required to make monthly rental payments equal to 25 percent of his adjusted income or 30 percent of the Department-approved market rent, whichever is greater. However, a tenant's rent cannot exceed the market rent. From November 1972 to August 1975, the average monthly market rent per Hanover Village apartment increased from \$223.14 to \$258.68.

In September 1975, 146 of the 151 Hanover Village tenants were receiving rent supplement assistance. The amount of assistance ranged from \$115.00 per month for a two-bedroom apartment (market rental rate of \$241.50) to \$191.00 per month for a three-bedroom apartment (market rental rate of \$274.00). The total amount of rent supplement assistance to Hanover Village tenants in calendar year 1975 was \$278,406. Five Hanover Village tenants were paying the full market rent.

Rents actually paid by tenants at section 236 and 221(d)(3) subsidized projects can be increased or decreased as a result of (1) recertifications of tenant income by project management or (2) changes in operating costs. Our review was concerned only with rental increases resulting from increased operating costs.

REASONS FOR THE PROJECTS'
RENTAL INCREASES AND
VALIDITY OF THE REASONS

Rental increases proposed by owners of section 236 and 221(d)(3) subsidized projects must be approved by the Department area office. The Department approves requests for rental increases when project operating costs have risen or when it has been demonstrated with reasonable certainty that utility rates, real estate taxes, or contracted services costs will rise in the future. The Department reviews the proposed increases and computes a maximum monthly rental income for the project. The project owners use this calculation as the basis for their revised rental schedule submission.

If the monthly rental income from all apartments does not exceed the maximum established by the Department, the new rental schedule will be approved. In this way, projects, at a specified percentage of

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occupancy, are assumed to continue to generate the income required for (1) payment of operating costs, including an allowable management fee, (2) mortgage amortization plus interest and mortgage insurance payments, and (3) owners' return on investment.

Sheridan Manor

The average monthly rental rate per Sheridan Manor apartment was \$121.63 when tenants were first accepted in October 1971. There have been two rental increases since: one effective September 1, 1973, which raised the average rental rate to \$136.36 and one effective July 1, 1975, which increased the average rate to \$153.43.

Rental increases approved for the project on July 1, 1975, were based primarily on calendar year 1974 costs. The increases averaged \$17.07 a month per apartment and ranged from \$15.80 a month for a one-bedroom apartment to \$21.47 a month for a four-bedroom apartment. The \$17.07 average monthly rental increase for all apartments was based on the following justification.

- An increase in annual operating expenses of about \$25,000, including about \$19,500 for real estate taxes, added \$10.65 to the average monthly rent.
- An increase in the owners' equity (due to increases in the project's construction costs determined at final settlement) and the resultant effect on return on investment added \$4.29 a month to the average rent.
- An increase in the allowable management fee and a contingency for vacant units added \$2.13 to the average monthly rent.

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Our examination of the validity of the costs allowed by the Department in computing the July 1, 1975, rental increase showed that the following costs should not have been included in the rent recomputation.

| | Annual <u>mount</u> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------|
| Overallowance for taxes: The Department allowed all local estate taxes included in the project's 1974 financial statements. However, this amount included past-due taxes from 1973. | \$14,846 |
| Duplicate allowance for decorating, repairs, and ground expenses: The Department permitted Sheridan an allowance of about \$11,000 for decorating, repairs, and ground expenses. The Department believes this type of allowance is necessary to help projects accumulate funds to meet additional maintenance expenses as the projects get older. However, the Department also permitted including expenses incurred during 1974 which are covered by the allowance. Therefore, the expenses incurred duplicated those provided for by the allowance. | 2,566 |
| Christmas bonuses: Sheridan's miscellaneous expense account included \$425 which represented Christmas bonuses paid to the onsite staff. This expense is more appropriately one of the managing agent's or owner's rather than one which can be attributed to project operations. | <u>425</u> |
| Total | <u>\$17,837</u> |

Hanover Village

The average monthly economic rent per apartment at Hanover Village was \$223.14 when the project was first available for occupancy in November 1972. Since then, a rental increase effective August 1, 1974, raised the average to \$248.64 and the latest increase, which was effective August 1, 1975, raised it to \$258.68.

Rental increases approved for the project on August 1, 1975, averaged \$10.04 a month and ranged from \$10.25 a month for a one- or two-bedroom apartment to \$10.00 a month for a three-bedroom apartment.

The \$10.04 monthly average rental increase for all apartments was based on the following justification.

- Actual and anticipated increases in project operating expenses, such as taxes and utilities, added \$10.24 to the average monthly rent.
- Correcting a Department error in computing the owners' return on investment for the preceding rental increase added \$7.23 to the monthly average rent.
- Reducing the allowable management fee netted against an increase in the contingency for vacant units reduced the average monthly rent by \$6.15.
- An increase in the project's commercial income reduced the average monthly rent by \$1.28.

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Our examination of the validity of the costs allowed by the Department in computing the August 1, 1975, rental increase showed that the following costs should not have been included in the rent recomputation.

| | <u>Annual amount</u> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------|
| Overallowance for salaries: The Department approved duplicate allowances for payroll costs because of a misinterpretation of financial data submitted by the project. | \$ 8,467 |
| Overallowance for water and sewer costs: Estimates for these costs were too high because they included arrearages from 1973 as well as 1974 costs. | 4,850 |
| Overallowance for electrical power rate increase: The Department arbitrarily allowed a 15-percent rate increase for electrical power; however, only a 4-percent increase was approved during 1975. The Department's allowance was inconsistent with its guidelines which require that utility increases be readily foreseen and determined with reasonable accuracy. | 3,800 |
| Overallowance for real estate taxes: Taxes were overestimated on the basis of erroneous data provided to the project by the mortgagee. | 976 |
| Overallowance for natural gas rate increase: The Department arbitrarily allowed a 15-percent rate increase for gas; however, only a 10-percent increase was approved in 1975. This was inconsistent with Department guidelines which require that utility increases be readily foreseen and determined with reasonable accuracy. | <u>500</u> |
| Total | <u>\$18,593</u> |

Conclusions and recommendations

The latest monthly rental increases at Sheridan Manor and Hanover Village were approved by the Department primarily on the basis of increases in operating expenses, such as utilities and taxes. We concluded that the amounts of the increases were excessive because certain costs should not have been included in the rent recomputations leading to the increases.

To insure that Sheridan Manor and Hanover Village tenants pay the appropriate rents based upon each project's operating requirements, we recommend that the Secretary of Housing and Urban Development require the Philadelphia area office to:

- Determine the proper rental rates to be charged the tenants of the two projects. The office should take into consideration those costs which should not have been included in the rent recomputations, as well as changes in other project income and expense accounts which may have occurred during 1975.
- Effect rental rollbacks if it determines that the rental rates charged since the dates of the latest increases were excessive. Rollbacks should be made retroactive to the dates of the increases.

Agency comments

The Department's Philadelphia area office officials agreed that the costs we identified should not have been included in computing the rents at the two projects. After eliminating these costs and considering certain changes which occurred in some income and expense accounts during calendar year 1975 project operations, we computed the appropriate average monthly rents for the projects to be \$2.09 less than the rent approved for Sheridan Manor and \$8.48 less than the rent approved for Hanover Village. 702

Rather than ordering immediate rollbacks in the rents at the two projects, however, Department officials requested the owners to submit certified financial statements for calendar year 1975 so that current income and expenses could be recognized in determining rents which should be charged by the projects. Department officials stated that if the results of the projects' operations during 1975 show that a rent rollback is warranted, such actions will be taken retroactive to the dates of the rent increases--July 1, 1975, for Sheridan Manor and August 1, 1975, for Hanover Village.

A rent rollback, for example, of \$2.09 at Sheridan Manor or of \$8.48 at Hanover Village, does not mean that all tenants would benefit to the full extent of the reduction. Tenants of both projects who are currently paying 25 percent of their income for rent will receive no benefit from a rental reduction. Hanover Village tenants who are paying a percentage of the market rent will benefit from the reduction generally to the extent of that percentage. Sheridan Manor tenants who are paying the basic rent and the five Hanover Village tenants who are paying the full market rent will receive the full benefit of the rental reduction. That portion of any rollback not realized by the tenants will be realized by the Federal Government.

TENANTS' RIGHTS IN SECTION 236
AND SECTION 221(d)(3) PROJECTS

Sections 236 and 221(d)(3) of the National Housing Act are silent about a tenant's right to participate in the management and decision-making process affecting requests for rental increases. Local housing authority officials in Wilkes-Barre and Luzerne County and attorney of the Luzerne County Legal Services Association and Pennsylvania Department of Community Affairs said no State or local laws or regulations provide tenants with specific rights for participating in decisions affecting rental increases.

Discussions with Department officials, however, indicated that tenants in sections 236 and 221(d)(3) projects are, by Department regulations, afforded the opportunity to comment on proposals for rental increases. No other rights to participate in the management and decisionmaking process are provided to the tenants.

Because tenant participation in proposals to increase rents was considered to be highly desirable and because the need for a national policy in this area was recognized, on October 14, 1974, the Department amended its regulations to implement new procedures for requesting rental increases. Basically, these procedures (1) require project owners to notify tenants, 30 days before filing, of their intent to request Department approval to increase rents, (2) provide an opportunity for tenants to make written comments on the proposed increase to the owners and to the Department, and (3) require tenants to be notified of the reasons for approval or disapproval of requested increases.

Our review showed that these procedures were followed at both projects. At Sheridan Manor, notice to tenants of the intention to file for a rate increase was posted on December 1, 1974, along with details of the reasons for the proposed increase. On formally applying

to the Department for the rate increase on January 30, 1975, the project owners certified that the notice was posted as required by the Department and that regulatory requirements had been met. The tenants were notified of the Department's approval of the rental increase to become effective July 1, 1975, through another posting at the project.

At Hanover Village a notice to residents was posted by the owners on January 28, 1975, of their intention to request a rental increase and the reasons for it. On February 27, 1975, the owners formally applied to the Department for the increase and certified that the project's tenants had been notified as required. The tenants were again notified as required when the Department approved the rental increase on June 26, 1975, to become effective August 1, 1975.

A review of Department files showed that written comments had been received from tenants of both projects concerning the proposed rental increases--44 letters and a petition with 130 signatures were received from Sheridan Manor tenants; 21 letters were received from Hanover Village tenants. The point of the letters and the petition was that the tenants could not afford the increases. Department officials said that, while the contents of the tenants' letters were considered, they decided to approve the rental increase since one of their overriding concerns was the financial integrity of each project.

IDENTITY OF INTERESTS AMONG PRINCIPALS
IN SECTIONS 236 AND 221(d)(3) PROJECTS

Identity of interests is a term used to describe a relationship between two parties in which there is a commonality of interest caused by financial or family ties. While identities of interest are not prevented by Department regulations, the regulations do require disclosing existence of certain of these relationships.

Section 227 of the National Housing Act (12 U.S.C. 1715r) sets forth certification requirements for builders' actual cost which, by reason of the definition of actual cost, raises the question of identities of interest between mortgagors and general contractors. The Department's implementing regulations require, for example, that identities of interest between the mortgagor and the architect and with the general contractor, subcontractors, suppliers, and equipment lessors be disclosed to the Department. The purpose for the disclosure is to (1) aid in determining a project's actual cost by providing for the proper application of a general contractor and sponsor's profit and risk allowance and (2) help to properly set the architect's fee and inspection responsibilities.

Identities of interest between the mortgagor and the general contractor existed for both Sheridan Manor and Hanover Village. As required, the relationships were disclosed to the Department before the projects' construction.

The Department also requires that owner-managing agent relationships be disclosed in what is known as the management plan for the project. The Department does not object to this owner-managing agent relationship provided the management is considered competent and that only certain allowable salaries are included in rent computations. One Department official said that an owner-manager relationship is regarded as a healthy situation because of the belief that the interests of both the Department and the owners will be better protected.

At the time of our review owner-manager relationships, both of which had been properly disclosed, existed at Sheridan Manor and Hanover Village.

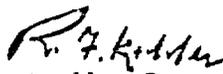
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As your office requested, we did not give the Department or the other parties mentioned an opportunity to formally comment on this report. However, we discussed the report with Department officials.

As agreed with your office, we are sending copies of this report to the Senate and House Committees on Government Operations and on Appropriations, to the Director, Office of Management and Budget, and to the Secretary of Housing and Urban Development.

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Sincerely yours,


ACTING Comptroller General
of the United States