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SINGLE-FAMILY HOUSING

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

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GAO/T-RCED-00-180

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to discuss our report that you are releasing today on the Department of Housing and Urban Development's (HUD) implementation of its management and marketing contracts.[1] HUD introduced these contracts nationwide last year as a means of disposing of the inventory of single-family properties that the Department acquires through foreclosures. The contractors are responsible for all management and marketing activities, ranging from inspecting the properties to ensure that they are presentable to listing and selling the properties.

In summary, our work showed that HUD has experienced widespread problems with the management and marketing contracts since they started in April 1999. Property maintenance and security, which was a problem under HUD's previous property disposition approach, remains a significant problem. Although monitoring improvements have aided HUD's ability to detect such problems, these improvements have not had a sufficient impact in remedying them. In addition, older properties have accumulated in inventory as the contractors have focused their sales efforts on the newly acquired, more saleable properties. Also, while HUD encourages contractors to sell properties quickly, it does not provide incentives for the contractors to focus on properties that have been in inventory for a long period of time.

Background

HUD, through its Federal Housing Administration, helps finance home purchases by insuring private lenders against losses on mortgages for single-family homes. If a borrower defaults on a loan and the loan is subsequently foreclosed, the lender may file a claim for most of its losses with HUD. The lender transfers the title to the home to HUD after the claim is paid. HUD manages and sells the property through its property disposition program. The property disposition program's mission is to sell these properties in a manner that expands homeownership opportunities, strengthens neighborhoods and communities, and ensures a maximum return to the fund.

[1] *Single-Family Housing: Stronger Measures Needed to Encourage Better Performance by Management and Marketing Contractors* (GAO/RCED-00-117, May 12, 2000).

As part of an effort to streamline operations and reduce costs, HUD began a pilot program in 1996 to test the feasibility of contracting out the management and sales functions of its property disposition program. HUD determined that the pilot was successful and in March 1999, began contracting out the management and marketing of its single-family property inventory when it awarded 7 companies a total of 16 contracts. The contractors are responsible for all activities associated with managing and marketing the properties which includes having the properties appraised, securing the properties to prevent unauthorized entry, inspecting the properties to ensure that they are clean and in presentable condition, listing the properties for sale, and selling them. For these services, HUD pays the contractors a fee that is based on a percentage of the property's selling price. Each contract covers a different geographic area under the jurisdiction of one of HUD's four homeownership centers.[2]

The Director of the Real Estate Owned Division in each of the four centers is responsible for monitoring contractors' performance in the respective center's jurisdiction. Homeownership center staff manage and conduct the monitoring and prepare monthly assessments on contractors' performance. The homeownership centers have a number of resources upon which they can draw to aid them in making these assessments. For instance, to assist in HUD's oversight, third-party contractors inspect 10 percent of the properties handled by each management and marketing contractor. Also for oversight purposes, another national contractor follows a HUD checklist to review 10 percent of the management and marketing contractors' property case files each month. In addition, the center's program support staff conduct follow-up property inspections and file reviews, as well as a monthly on-site review at the contractors' offices. As part of the analysis, the HUD staff assign a risk rating of low, medium, or high to the contractor's performance on each of 11 performance dimensions such as claims review, property maintenance, and sales procedures.

Weaknesses Exist in HUD's Ability to Ensure Contractors' Better Performance

Our work on HUD's new contracts for managing and marketing its inventory of single-family properties shows that further improvement is needed to ensure better performance by its contractors. We found that HUD has experienced widespread problems with the contractors

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

since the program started in April 1999, including HUD's termination of its largest contractor--InTown Management Group. Property maintenance and security, which was a problem under HUD's previous property disposition approach, remains a significant problem. While monitoring improvements have improved HUD's ability to detect such problems, these improvements have not had a sufficient impact in remedying them.

Although the contractors have been more aggressive at marketing properties--for example, they use the Internet and broad-listing brokers,[3] and other services to publicize the properties and enhance sales--early assessment reports prepared by the homeownership centers indicated that most of the contractors had problems in carrying out some of their management responsibilities. One of the areas in which most of the contractors have had particular performance problems is that of property maintenance and security. Contractors' failure to properly secure and maintain the properties assigned to them may cause a decline in property values and have a negative impact on surrounding neighborhoods. In the homeownership center staff's' monthly assessment reports of contractors' performance for each month from May through November 1999, the staff's assessments depict serious performance problems in terms of property maintenance for over half of the contracts reviewed.[4] Even in the assessment reports for November 1999, 8 months after the initial contract start-up period, 11 of the 13 contracts that we reviewed had serious problems in at least one of the performance dimensions.

We corroborated our findings that these problems existed during our visits to 16 properties. Several of the properties we visited were not properly secured or maintained. For example, one of the homes in Washington, D.C., was poorly maintained (see fig. 1), had an open front window and rear door, and had beer bottles inside; furthermore the backyard was overgrown with brush and weeds. A property in Philadelphia that was listed for sale by the contractor still had the previous maintenance contractor's sign on the front door, unrepaired vandalism along the side of the house (see fig. 2), trash in the rear courtyard, and an unsecured opening into the house.

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

[4]These data exclude the assessment reports related to the InTown Management Group's contracts.

Through experience HUD is learning that it has limited means to address poor performance by the contractors. Although the homeownership centers have identified performance problems, have brought them to the contractors' attention, and have pressed for improvements, these actions have not always yielded the improvement desired. For instance, in September 1999, the Department issued a “letter of concern” to one of the contractors regarding the contractor’s inadequate progress in maintaining properties in presentable condition. HUD also issued a deficiency letter regarding poor property maintenance to another contractor. While a HUD official told us that neither of these contractors was terminated and that their performance has subsequently improved, the assessment reports prepared by homeownership center staff regarding the performance of these two contractors show that as recently as November 1999, over half of the properties reviewed for each of these contractors were in less than satisfactory condition. Aside from pointing out deficiencies in the monthly assessment reports, issuing letters of concern or deficiency, or taking steps toward terminating contracts, HUD staff do not have other tools available to address performance deficiencies. The contracts do not provide for penalties to enforce compliance with the contract terms. In this regard, as part of its audit of FHA’s fiscal year 1999 financial statements, KPMG LLP, in a report on FHA’s internal controls, recommended that FHA devise a method of penalizing management and marketing contractors that routinely do not comply with performance requirements.[5] The report noted that penalties would effectively communicate the importance of strictly adhering to HUD’s guidelines.

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

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

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

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

HUD's inventory of foreclosed properties steadily increased during fiscal years 1996 through 1999. (See fig. 3.) However, the inventory began to decline in fiscal year 2000. In the first 3 months following the implementation of the management and marketing contracts (Apr. through June of 1999), the number of properties in HUD's inventory increased, reaching approximately 52,000 properties by the end of fiscal year 1999. Within a month, however, the contractors had increased their sales, which, by that time, were outpacing acquisitions. (See fig. 4.) As of February 2000, the inventory was down to about 47,000 properties. The structure of HUD's contracts, which provide full payment to the contractors only after a property is sold, provides an incentive for good sales performance.

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

Although the contractors have increased their sales of HUD properties, the inventory of older properties, or those that have remained in the inventory for 6 months or longer, has increased. The contractors are selling more of the newer properties coming into the inventory. Properties that were in the inventory for 6 months or longer accounted for 42 percent of the total inventory at the end of February 2000--up from 30 percent in April 1999. The properties in the inventory for 1 year or longer increased from 10 to 17 percent of the total inventory for this same time period. (See fig. 5.) According to a HUD contracted study,[6] in the real estate industry, only about 2 to 3 percent of the properties remain in inventory for over a year. In 1995, we reported that properties in the inventory for longer periods of time are sold for proportionately less.[7] In addition to the potential for deterioration of the properties, which can reduce their value, HUD also incurs some costs as the properties remain in the inventory, such as property taxes, utility costs and lost sale revenue.

HUD is aware of the problems with older properties in the inventory and encourages the contractors, through frequent telephone calls, to focus on the older properties. In addition, on March 1, 2000, HUD announced a new Good Neighbor Program whereby it will sell properties

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

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

that have been listed for over 6 months to local communities for $1. The program is too new for us to know what effect it may have on HUD's inventory of older properties or on the fund.

Furthermore, while HUD has an extensive monitoring system to oversee contractors' performance, the system does not specifically address contractors' performance in selling aging properties. Thus, there are no specific incentives for the contractors to give attention to the older, potentially more-difficult-to-sell properties, or penalties if they do not. In contrast, the fee structure of the contracts provides an incentive for the contractors to sell properties quickly, which could lead the contractors to sell the newer, more marketable properties first.

Conclusion

Improvements are still needed to ensure that HUD's contractors perform the full range of functions required to manage and sell the single-family properties it acquires given the continuing problems that HUD, KPMG, and we have identified with property maintenance and security. HUD's available incentives and enforcement methods, short of contract termination, are not strong enough to ensure that the contractors are meeting their responsibilities in this area. In its internal control report as a part of its fiscal year 1999 audit of FHA's financial statements, KPMG recommended that HUD devise a method of penalizing management and marketing contractors that routinely do not comply with contract performance requirements. We agree that a more effective mix of incentives and penalties is needed.

HUD's contracts provide incentives for the contractors to sell properties quickly, and consequently, the inventory of properties has begun to decline. But HUD does not provide incentives to sell properties that have been in the inventory for a long period of time. These properties tend to worsen the longer they remain unsold and could possibly sell at a lower price than other properties in the inventory. As a result, our report recommended that HUD develop more effective methods, such as specific incentives or penalties, to encourage contractors to reduce the number of properties that are in the inventory longer than 6 months.

Mr. Chairman, this concludes our statement. We would be pleased to respond to any questions that you or Members of the Subcommittee may have.

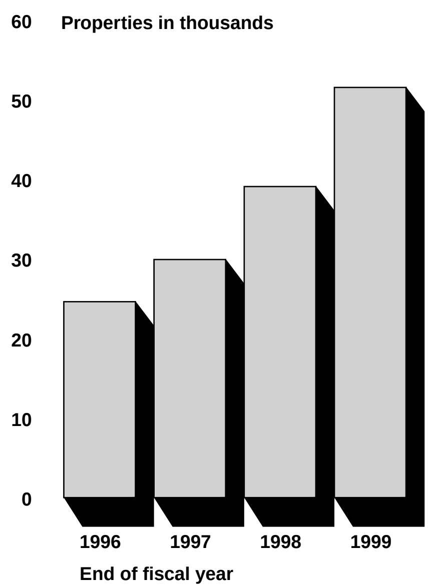
For further information regarding this testimony, please contact Stanley J. Czerwinski at (202) 512-7631. Individuals making key contributions to this testimony included Jacqueline Garza, Stan Ritchick, Paul Schmidt, Stewart Seman, Leigh Ward, and Steve Westley.

Figure 1: Unmaintained Washington, D.C., Property

Appendix I

Figure 2: Vandalized Philadelphia Property

Figure 3: HUD's Inventory of Single-Family Properties at the End of Fiscal Years 1996-99



Appendix I

Figure 4: Number of New Acquisitions Into the Inventory Compared With Sales by Month Since the Implementation of Management and Marketing Contracts

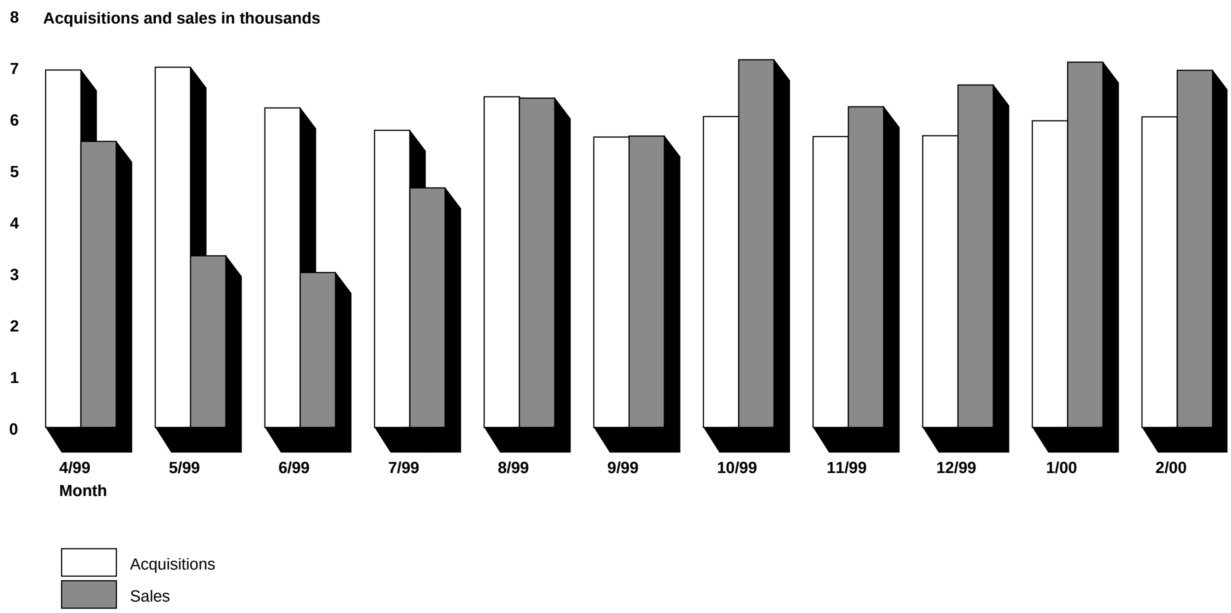
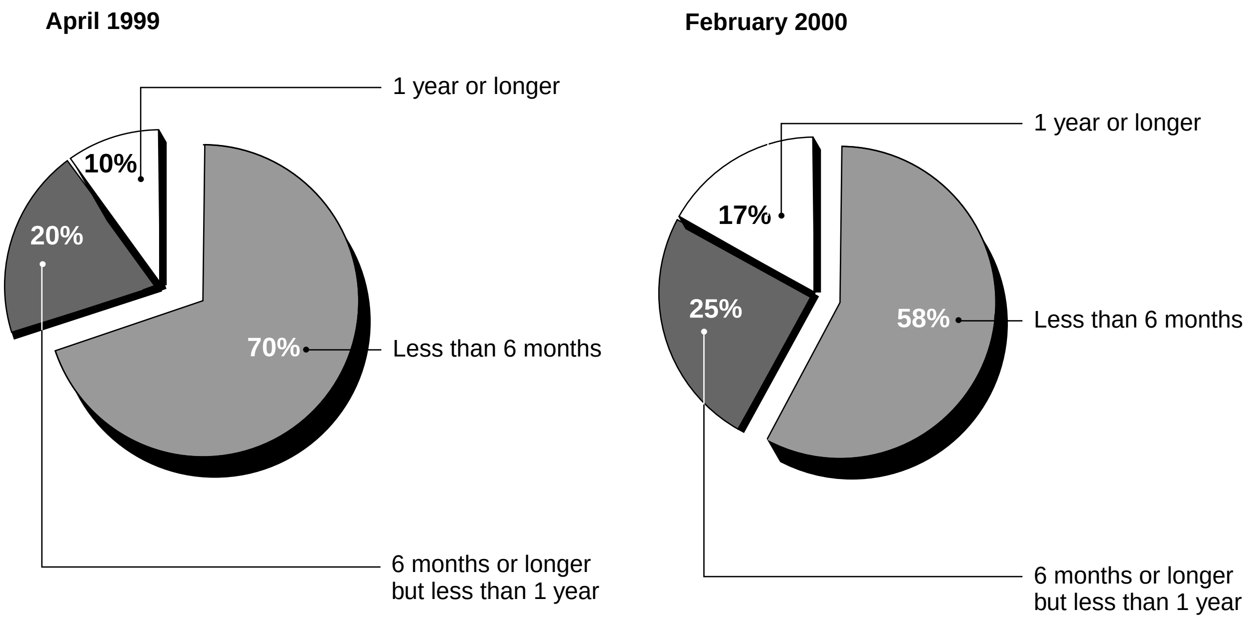


Figure 5: Percentage of Properties by Length of Time in HUD's Inventory in April 1999 Compared With Percentage in February 2000



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