

MILLENNIAL HOUSING COMMISSION
PRESERVATION TASK FORCE
BACKGROUND PAPER: OUTCOME-BASED COMPLIANCE REFORMS

OVERVIEW

This paper presents a proposal to replace the current compliance systems for subsidized rental housing with a new compliance system based on analogues from outside the housing sphere. This draft draws heavily from suggestions from George Caruso (NAHMA) and David Smith (Recapitalization Advisors).

ANALOGOUS COMPLIANCE SYSTEMS

Outside the housing sphere, the state of the art seems to be compliance systems that are very different from the systems we see in affordable housing. Three examples follow.

Aviation. The FAA accomplishes most of its pilot licensing and non-air-carrier monitoring through a system called Designated Examiners. DEs work in several areas, for example: medical qualification, pilot skill checks, and maintenance reviews. Some DEs are also professionals in other areas. For example, medical qualification reviews are performed by physicians holding FAA certifications. Similarly, pilot skill reviews are performed by FAA-licensed Certified Flight Instructors. DEs are private individuals, with certifications and / or approvals from the FAA. The pilot or company pays the examiner. Examiners have standards for independence not unlike CPAs and must undergo periodic recertification and review by FSDO (Flight Standards District Office), which is staffed by FAA employees.

Securities. The SEC in conjunction with AICPA and FASB has developed another private-sector-based model of self-regulation and disclosure. The matters being regulated arguably are more complex than subsidized rental housing programs. Compliance regulation for the most part is performed by the compliance departments of the securities firms themselves. Compliance departments are overseen periodically by CPAs. Less often, SEC staff weigh in on complex questions. Again, most compliance reviews all privately performed, on a fee basis with fairly well defined standards of independence and conduct.

Medicine. The intermediaries here are the state licensing boards, and the certification societies (for example, The American Academy of Family Practice). Again, compliance monitoring is shared between government (in this case, the States, and private industry).

Common Themes. The following common themes are apparent; the following uses the securities industry as an example.

- **Independent private contractors.** Independent third parties (CPAs) audit the books and records. Contractors are certified and operate under well-defined ethical and independence standards.

- **Government standards.** Regulatory standards are set through a joint public – private mechanism not unlike negotiated rulemaking.
- **Self-disclosure and explanation.** Compliance reviews consist primarily of review of materials provided by the entity being reviewed. Any exceptions are clearly noted and management is required to explain them.
- **Self-certifying.** Contractors (CPA auditors) certify their reports, which in turn are delivered to regulatory agencies.
- **Self-funding.** Their costs are included in the operating budget. Compliance contractors are hired and paid by the entity being monitored.

AFFORDABLE RENTAL HOUSING COMPLIANCE SYSTEMS

Typically, compliance reviews are performed directly by government staff. Compliance guidelines are established by government, generally with stakeholder comment but usually not in negotiation with stakeholders. Compliance is usually tied to regulatory or administrative requirements and often emphasizes the process and documentation (ability to produce paper demonstrating compliance with rules) instead of outcomes (whether this is good housing provided to income-eligible residents at affordable rents).

ELEMENTS OF A NEW AFFORDABLE HOUSING COMPLIANCE SYSTEM

A new system should be designed around these principles:

- **Outcome-oriented.** Compliance should focus on the relevant outcomes. So long as these outcomes are achieved, other process-oriented requirements should be waived:
 - **Rent affordability** (defined by rents capped according to program guidelines).
 - **Income eligibility** (as demonstrated by resident income certification files).
 - **Physical soundness** (measured by an inspection report).
 - **Financial soundness** (measured by financial analysis). This outcome would be relevant for properties with government-backed financing.
- **Independent Private Contractors.** Monitoring would be done not by government but by private compliance monitors who deliver reports according to agreed standards and who are independent of the entity being monitored. An industry would rapidly develop.
- **Certified Contractors.** Trade associations (such as NAHMA or NAHB) could create a suitable training syllabus and certify contractors, analogous to the functions performed by the AICPA for the securities industry.
- **Government Reporting Standards.** Government would establish appropriate reporting standards and certifications, including the absence of a conflict of interest, required of

monitoring contractors. The process for establishing requirements would be analogous to a negotiated rulemaking process, in which stakeholders have a meaningful role beyond the simple right to comment.

- **Self-funding.** Compliance monitoring costs should be built into the operating budgets of affordable properties and paid as property expenses just like the audited financial statement fees.
- **Self-reporting.** Owners would be obligated to self-report (i.e., cause compliance reports to be prepared and filed) and could be financially penalized for failure to do so.
- **Resident feedback.** The system should build in a mechanism for resident feedback (suitably leavened so that resident comments are heard seriously but not taken as gospel absent verification, perhaps by having the compliance monitor examine material complaints).
- **Periodic improvements.** Over time, reporting systems improve and reporting needs change. It would be desirable to structure a cycle (perhaps annually, perhaps biannually) of prospective administrative changes to the government reporting standards.

CONVERTING TO A NEW COMPLIANCE SYSTEM

Assuming a new compliance paradigm is desired, it can be approached for both new programs and existing ones:

- **New programs.** The above paradigm should be adopted for any new production or preservation program.
- **Existing programs.** Changing to the new program would be voluntary; that is, owners would be given the option to switch. Once they elect in to the new paradigm, they may not reverse field. Upon an election, the parties would sign a new regulatory agreement (to be developed for each program) that preserves the economics but changes the reporting responsibilities (and, to the extent necessary, authorizes the Compliance Monitoring Fee as an eligible property expense).