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Department Of Housing And Urban Development's Comparison Of Costs Under Sections 202 And 236 For Housing Projects For The Elderly

B-167637

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

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AUG 1,1972

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D C 20548

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Dear Mr Chairman

AGC00023

This is our report on our review of the Department of Housing and Urban Development's comparison of costs under sections 202 and 236 for housing projects for the elderly

Our review was made pursuant to your request of July 23, 1971, and subsequent discussions with our representatives

We did not obtain written comments from the Department of Housing and Urban Development on the matters discussed in this report

We plan to make no further distribution of this report unless copies are specifically requested, and then we shall make distribution only after your agreement has been obtained or public announcement has been made by you concerning the contents of the report

We trust that the information furnished will serve the purpose of your request

Sincerely yours,

Comptroller General
of the United States

The Honorable Harrison A Williams, Jr
Chairman, Subcommittee on Housing
for the Elderly
Special Committee on Aging
United States Senate

SEN05505

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ABBREVIATIONS

GAO General Accounting Office

HUD Department of Housing and Urban Development

CHAPTER 1

INTRODUCTION

By letter dated July 22, 1971, the Chairman, Subcommittee on Housing for the Elderly, Senate Special Committee on Aging, requested the Department of Housing and Urban Development (HUD) to furnish the Subcommittee with a comparison of (1) the costs related to the planning, construction, and operation by nonprofit organizations of selected housing projects for the elderly under the section 202 and section 236 programs authorized by the Housing Act of 1959 (12 U.S.C. 1701q) and the National Housing Act (12 U.S.C. 1715z-1), respectively, (2) the cost of Government financing under each program, and (3) rents payable by tenants under each program (See app I) By letter dated October 1, 1971, HUD replied to the request (See app. II)

By letter dated July 23, 1971, the Chairman requested the General Accounting Office (GAO) to evaluate HUD's cost comparison. Our review of HUD's cost comparison was made pursuant to this request and subsequent discussions.

Under the section 202 program, HUD made long-term loans to project sponsors at interest rates not to exceed 3 percent. Under the section 236 program, HUD insures mortgage loans made by private lenders to project sponsors at interest rates established by HUD and pays all interest in excess of 1 percent on the loans The Chairman requested that, in comparing the various cost elements of a project constructed under either of the two programs, HUD use as the basis for its comparison three recently constructed and operational section 202 projects, of different sizes and in different geographic locations, which were considered to be typical of the projects authorized under the section 202 program The comparison was to include an explanation of all significant variances in planning, construction, and operating costs resulting from application of the section 236 program criteria

The Chairman requested that the financing costs incurred by the Government under the two programs be computed for each selected project HUD was asked to assume, for purposes of the calculations, that all Government funds required to finance the loan and subsidy outlays were obtained from Treasury borrowings with interest at the rates of 5, 6, and 7 percent

The basic cost to the Government to finance the section 202 program was to be the capital sum provided by the Government at 3 percent interest The comparable cost under the section 236 program was to be the estimated capital outlay of the Government to pay a subsidy on interest costs incurred by the sponsor on the project loan Interest subsidy costs were to be computed on the basis that interest on private financing was at the maximum rate (7 percent) permissible for section 236 projects and that the Government made interest subsidy payments equal to the difference between the interest rate of 7 percent and that of 1 percent which must be paid by the project sponsor

Appropriate consideration was also to be given to the Federal income taxes that would be paid under the two methods of financing.

We made our review primarily at HUD's central office in Washington, D C., where we interviewed HUD officials and examined pertinent project records Our review included discussions with HUD officials at the Atlanta, Ga., regional office; the Washington, D.C., and Chicago, Ill , area offices; and the Coral Gables, Fla , insuring office and an examination of pertinent field office records We also inspected the projects used in HUD's cost comparison, located in Washington, D C., and Kensington, Md ; Fort Myers and Miami, Fla ; and Oak Brook and Elgin, Ill

SECTION 202 AND SECTION 236 HOUSING PROJECTS FOR THE ELDERLY

Prior to July 1970 federally subsidized housing for the elderly (other than low-rent public housing) was provided under the program authorized by section 202 of the Housing Act of 1959 Section 202 authorized HUD to make long-term loans bearing interest at a maximum rate of 3 percent to public agencies, cooperatives, limited-profit corporate sponsors, and nonprofit corporate sponsors of rental housing and related facilities for the elderly and their families and for handicapped persons Such loans were generally equal to 100 percent of a project's development costs and were repayable over a 50-year period

Tenants in section 202 projects pay rents which are intended to cover loan principal and interest installments, project operating expenses, and a reserve for repair and replacement of capital items Also HUD, as an added safety factor in establishing monthly rental rates, requires that the monthly revenue be based on a 95-percent-occupancy rate, because 100-percent occupancy may not be realized Such rents have no relationship to tenant incomes

In July 1970 HUD stopped using the section 202 program for new housing for the elderly and directed that such housing be provided under the program authorized by section 236 of the National Housing Act Section 236 authorizes HUD to administer a multifamily loan insurance program under which HUD insures mortgage loans made by private lenders at interest rates established by HUD (currently 7 percent) and pays all interest in excess of 1 percent on the loans. A mortgage loan may be made in an amount equal to 100 percent of a project's development costs and is payable over a 40-year period.

Each tenant in section 236 projects is required to pay a monthly rent equal to the greater of (1) a basic rent or (2) 25 percent of his monthly income. The monthly rent, however, may not exceed what is determined to be a fair-market rent. Basic rents are intended to cover loan principal and interest installments, assuming a 1-percent loan; project operating expenses; and a replacement reserve for certain capital items. HUD also considers a 95-percent-occupancy rate to be reasonable to allow for possible vacancies or nonuse. Any rents collected by the project sponsor in excess of the basic rents are required to be returned to HUD.

Pursuant to section 202, HUD approved loans of about $574 million during the period 1960 to 1970 for the construction of 335 projects, which provided about 45,000 housing units.

The following table summarizes the number of construction starts for housing projects for the elderly that were insured by HUD pursuant to section 236 during the period 1969 to 1971

	Number of projects	Number of units	Amount of insured mortgage loans (millions)
1969	3	446	$ 6.4
1970	72	11,536	187 4
1971	44	7,371	125.0
	119	19,353	$318.8

CHAPTER 2

HUD'S COMPARISON OF COSTS RELATING TO SECTION 202 AND SECTION 236 HOUSING PROJECTS FOR THE ELDERLY AND GAO'S EVALUATION

HUD's comparison of costs relating to section 202 and section 236 housing projects for the elderly consisted basically of an analysis of (1) the actual costs of three section 202 housing projects and (2) the adjusted costs of three comparable projects. The comparative analysis consisted of three parts: (1) comparative development costs of projects, (2) long-range costs to the Government, and (3) tenant incomes and rents. A discussion of the procedures used by HUD in making its analysis and our evaluation follow.

SELECTION OF SECTION 202 PROJECTS

HUD selected for its analysis three section 202 housing projects, located in Washington, Oak Brook, and Fort Myers, which it considered met the selection criteria--(1) projects recently completed, (2) different-sized projects, and (3) projects located in different geographic areas--specified by the Subcommittee. HUD officials told us that these projects had been selected from 16 section 202 projects whose construction began between August 1968 and July 1970.

Our analysis of the 16 projects showed that (1) they ranged in size from 80 to 231 apartment units and averaged 161 units, (2) the unit cost ranged from about $12,200 to $15,200 and averaged $13,700, (3) the mortgages on these projects ranged from about $1.1 million to $3.3 million and averaged $2.2 million, and (4) all were high-rise structures ranging from four to 16 stories.

GAO evaluation

The three projects selected by HUD for its analysis, in our opinion, were fairly representative of the 16 recently constructed section 202 projects from which they were selected and met the selection criteria specified by the Subcommittee. All three projects were recently completed--two in 1971 and one in 1970. The projects were of different sizes--100, 150, and 180 units--and they were located in different areas of the country--Illinois, the District of Columbia, and Florida.

COMPARATIVE DEVELOPMENT COSTS

HUD separated the development costs for each of the three selected section 202 projects and the three comparable projects into the following components.

--Planning (preconstruction): preliminary expenses, organization and development expenses, and legal and administrative expenses.

--Land.

--Construction: construction costs; architect fee; engineering fee; resident inspector's fee; and interest, insurance, and taxes during construction period.

--Other title and recording fee, financing fee, HUD examination fee and mortgage insurance premium, Federal National Mortgage Association fee, and contingency cost.

Actual project data was used by HUD in computing the section 202 development costs. In estimating the development costs which would have been incurred if section 236 program criteria had been applied to the three selected projects, HUD used as its basis projects which it considered to be comparable to the section 202 projects.

The comparable projects were projects which had loans insured by HUD and which were located near the three section 202 projects. For the Washington section 202 project, a project approved for loan insurance under section 236 and located in Kensington was selected as a comparable project; for the Oak Brook project, a project approved for loan insurance under section 221(d)(3) of the National Housing Act and located in Elgin was selected; and for the Fort Myers project, a project approved for loan insurance under section 207 of the National Housing Act and located in Miami was selected.

HUD headquarters officials informed us that the comparable projects selected to estimate the related section 236 costs for the section 202 projects were considered to be the most similar projects in the three HUD regions in which the section 202 projects were located.

HUD made certain adjustments to the actual construction costs of the three comparable projects so that their characteristics were theoretically the same as the characteristics of the three section 202 projects. HUD assumed that the cost of land under section 236 was the same as that under section 202. As discussed in our evaluation of HUD's analysis of comparative development costs (see p. 18), we believe that HUD's use of comparable projects to estimate section 236 development costs for the section 202 projects was not the most practicable method of estimating what these projects would have cost under section 236 criteria. Accordingly, our review did not include an evaluation of the various adjustments that were made.

The procedures used by HUD to estimate the section 236 development costs for each of the three projects are discussed below

Washington

The section 202 projects selected by HUD for analysis in Washington was a five-story structure having 100 rental units--80 efficiency apartments and 20 one-bedroom apartments--and a total area of about 61,000 square feet. Construction of the project began in 1969 and was completed in 1971. To estimate section 236 costs for this project, HUD selected as a comparable project a six-story structure having 101 rental units--54 efficiency apartments and 47 one-bedroom apartments--and a total area of about 81,000 square feet Construction of the project also began in 1969 and was completed in 1971

A comparison of the actual development costs for the section 202 project and the estimated development costs which HUD assumed would have been incurred under section 236 is shown in the following table.

	Section 202	Section 236	Difference
Planning	$ 43,625	$ 25,800	$ 17,825
Land	110,000	110,000	-
Construction	1,362,200	1,151,924	210,276
Other	4,175	107,905	-103,730
Total	$1,520,000	$1,395,629	$124,371

As shown above, section 202 development costs exceeded section 236 development costs by $124,371--the difference was attributed principally to higher construction costs offset partly by lower "other" costs. For section 236 projects the other costs include financing and other fees and mortgage insurance premiums which are not applicable to section 202 projects because such projects were financed with HUD loans.

We inspected both projects and noted that the projects had certain obvious differences which, in our opinion, could have some effect on construction costs. The section 202 project, although it had less floor space, was built on a special foundation and had central air conditioning, exterior balconies on the end apartment units, a barber shop, a banquet room, and central dining facilities; the comparable project did not have these features.

We were advised by HUD officials that only two features in the comparable project, in addition to floor space, required adjustment to equate it with the section 202 project: (1) the special foundation and (2) the central air-conditioning system HUD officials justified the adjustments on the basis of HUD's building experience. For example, HUD estimated that the cost of central air conditioning exceeded the cost of individual-room air conditioning by $200 a unit.

Oak Brook

The section 202 project selected by HUD for analysis in Oak Brook was a six-story structure having 150 rental units--100 efficiency apartments and 50 one-bedroom apartments--and a total area of about 102,000 square feet. Construction of the project began in 1970 and was completed in 1971. To estimate section 236 costs for this project, HUD selected as a comparable project a nine-story structure having 96 rental units--16 one-bedroom apartments, 64 two-bedroom apartments, and 16 three-bedroom apartments--and a total area of about 113,000 square feet Construction of the project began in 1967 and was completed in 1968.

A comparison of the actual development costs for the section 202 project and the estimated development costs which HUD assumed would have been incurred under section 236 is shown in the following table.

	Section 202	Section 236	Difference
Planning	$ 35,766	$ 14,000	$ 21,766
Land	60,000	60,000	-
Construction	2,105,899	2,290,360	-184,461
Other	-	176,701	-176,701
Total	$2,201,665	$2,541,061	-$339,396

As shown above, section 236 development costs exceeded section 202 development costs by $339,396--the difference was attributed principally to higher construction and other costs. This was the only project included in HUD's study for which section 236 development costs were higher

HUD considered the higher construction costs estimated under section 236 to be due to special construction techniques used in the section 202 project. The section 202 project utilized a stressed-concrete construction method for which HUD stated that no comparable data was available for projects financed under HUD's loan insurance programs. Therefore any savings resulting from the use of this construction method were not reflected in the section 236 estimate.

We inspected both projects and noted that, in addition to the difference in floor space and the stressed-concrete construction, there were several other obvious differences in the two projects that affected construction costs. The section 202 project had the following features which were not available in the comparable project

--Air conditioning
--Recreation room
--Lounge areas on each floor
--Medical offices
--Balconies
--Banquet room
--Central dining facilities
--Commissary
--Coin-operated laundry
--Safety handrails in corridors and bathrooms
--Craft-game room
--Wall-to-wall carpeting in corridors

The comparable project had indoor parking; the section 202 project had outdoor parking The comparable project also had facilities for a day nursery; such facilities are not constructed in section 202 projects for the elderly

HUD records showed that, in addition to an adjustment for the difference in floor space, the only adjustments made to equate the costs of the comparable project with those of the section 202 project were for the (1) differences in types of parking facilities, (2) air conditioning, (3) central dining facilities, (4) day nursery, (5) differences in construction costs due to inflation, and (6) differences in the number of rental units.

Fort Myers

The section 202 project selected by HUD for analysis in Fort Myers was a 16-story structure having 180 rental units--90 efficiency apartments and 90 one-bedroom apartments--and a total area of about 125,700 square feet. Construction of the project began in 1968 and was completed in 1970. To estimate section 236 costs for this projects, HUD selected as a comparable project a project consisting of three structures, each eight stories high, having a total of 238 rental units--97 one-bedroom apartments, 66 two-bedroom apartments, and 75 three-bedroom apartments--and a total area of about 296,000 square feet. Construction of the project began in 1971 and was completed in 1972.

A comparison of actual development costs for the section 202 project and the estimated development costs which HUD assumed would have been incurred under section 236 is shown in the following table.

	Section 202	Section 236	Difference
Planning	$ 56,783	$ 57,787	$ -1,044
Land	142,000	142,000	-
Construction	2,213,138	1,835,818	377,320
Other	28,077	154,395	-126,318
Total	$2,439,998	$2,190,000	$249,998

As shown above, section 202 development costs exceeded section 236 development costs by $249,998--the difference was attributed principally to higher construction costs and was offset partly by lower other costs

We inspected both projects and noted that, in addition to the difference in floor space, there were several obvious differences in the two projects, which, in our opinion, could have some effect on construction costs. For example, the comparable project was a luxury apartment complex having such features as a swimming pool, sauna baths, outdoor recreation facilities, and dishwashers. On the other hand the section 202 project had certain protective features for the elderly, such as safety handrails in corridors and bathrooms and an emergency buzzer system in each apartment.

HUD records showed that, in addition to an adjustment made for the difference in floor space, adjustments were made for the other project differences discussed above. HUD officials informed us that adjustments were made also for differences in construction costs due to inflation between the period of construction of the section 202 project and that of the comparable project and for variances in construction costs due to the locations of the two projects.

GAO evaluation

The Subcommittee requested a comparison of the costs of typical section 202 projects with estimated costs for these same projects if they had been authorized under section 236. We believe that HUD's use of comparable projects to develop the estimated section 236 project costs did not satisfy the Subcommittee's request.

As noted in preceding sections of this chapter, the comparable projects differed significantly from the three section 202 projects. Although HUD made adjustments to the cost of the comparable projects to compensate for certain differences, we believe that other significant project differences that could materially affect the estimated section 236 construction costs were not considered in HUD's analysis.

Although HUD made cost adjustments for certain of the obvious differences between the comparable projects and the section 202 projects, an in-depth analysis of all significant project differences having an effect on construction costs was not made.

For example, with respect to the Oak Brook comparison--the only one in which HUD estimated that section 236 development costs would exceed the development costs for the section 202 project--we were advised by an official of HUD's Chicago area office, the office responsible for developing the comparison, that the two projects included in the analysis had not been visited to ascertain which adjustments were necessary.

HUD Chicago area office officials accompanied us on an inspection tour of the section 202 project and the comparable project and acknowledged their lack of familiarity with the project differences. We found that the comparable project, which these officials had assumed had nine floors of living space, had only eight floors of living space--the lower floor was used principally for a lobby, an office, and tenant parking.

A meaningful application of HUD's technique of using comparable projects to estimate costs for specific projects would have required consideration of all project variables, such as

--Site conditions
--Construction techniques
--Construction materials
--Mechanical, heating, plumbing, and electrical equipment
--Appliances in apartment units
--Number of floors
--Number of apartment units
--Size of apartment units

HUD's use of comparable projects to develop estimated section 236 costs for the section 202 projects was not the most practicable method of estimating the costs of these projects under section 236 criteria. It is reasonable to assume that the cost of constructing a building under either the section 202 or the section 236 program would be essentially the same. We are dealing with a hypothetical situation involving estimating section 236 development costs for section 202 projects which had already been constructed. Therefore actual construction costs that were incurred in building the section 202 projects, except for differences in interest costs during the construction period and in architectural and engineering fees, are the best indication of the construction costs of these projects under the section 236 program.

According to HUD, architectural and engineering fees under section 236 are lower than under section 202. Under section 202 such fees are based on local American Institute of Architects' rates which are generally higher than rates authorized by HUD under section 236.

The only project development costs that would differ if the section 236 program criteria had been applied to the section 202 projects would be those costs peculiar to the mortgage insurance program, such as higher interest costs during construction (3 percent under section 202 and 7 percent under section 236); lower architectural and engineering fees; mortgage insurance premiums, examination, inspection, and financing fees, and certain other fees. Therefore a comparison of costs under section 202 and section 236 for the same projects would have been more responsive to the Chairman's request.

GOVERNMENT'S FINANCING COSTS

HUD compared the cost to the Government to finance each of the three section 202 projects with the cost applicable to the projects if they had been developed under section 236 criteria. Two comparisons were made--one assumed a 40-year loan and the other a 50-year loan. Although a section 236 mortgage loan is typically for 40 years and a section 202 mortgage loan is typically for 50 years, HUD used the same number of years in its comparison, to provide a basis consistent with a HUD presentation made before the Subcommittee in August 1971.

Actual section 202 development costs and estimated section 236 development costs were used as the loan amounts subject to long-term financing. The interest rates specified in the Chairman's letter to HUD--5, 6, and 7 percent for Treasury borrowings and 7 percent for privately financed section 236 loans--were used in the computations.

HUD computed the long-range costs incurred under section 202 by multiplying the difference between the interest cost to finance the loan at the Government's borrowing rates and the interest income (at 3 percent) received from the project sponsor by the 40-year and 50-year assumed loan terms.

HUD computed the estimated long-range costs under section 236 by multiplying the subsidy payments by the 40-year and 50-year terms. The subsidy payments by the Government represent interest payments on the loan equal to the difference between the 7-percent interest and the 1-percent interest paid by the project sponsor.

HUD advised the Subcommittee that administrative costs under either program were not significant and therefore were not considered in the comparison.

HUD's comparison of the Government's long-range financing costs for the three section 202 projects with the costs applicable to the projects if they had been developed pursuant to section 236 criteria is shown in the following table.

	Section 236	Section 202		
		5%	6%	7%
	(millions)			
40-year loan				
District of Columbia	$2.7	$0.9	$1.4	$1.9
Illinois	4.9	1.3	2.0	2.8
Florida	4.2	1.5	2.3	3.1
50-year loan:				
District of Columbia	3.4	1.2	1.9	2.6
Illinois	6.1	1.7	2.7	3.7
Florida	5.3	1.9	3.0	4.1

As shown above, HUD estimated that section 236 financing would be more costly to the Government than section 202 financing.

GAO evaluation

HUD's comparison of long-range financing costs to the Government for each of the section 202 projects with costs applicable to the projects if they had been developed pursuant to section 236 is not fairly presented, because such costs were based on development costs for projects which were generally not comparable. (See p. 17.)

Also HUD compared long-range financing costs under each program for periods of 40 years and 50 years, respectively. Because section 236 loans are typically for 40 years and section 202 loans are typically for 50 years, equating the loan periods for comparative purposes is not realistic. HUD recognized this in its analysis but justified the loan periods used on the basis that it was consistent with a presentation HUD had made in recent testimony before the Subcommittee. (See p. 35.) A comparison of long-range costs incurred by the Government under each of the two programs should be based on the actual mortgage terms normally experienced.

The Subcommittee requested that, for purposes of the calculations, HUD assume that all Government funds required to finance the loan and interest subsidy outlays were obtained from Treasury borrowings with interest at rates of 5, 6, and 7 percent. HUD computed long-range section 202 costs as the difference (net cash flow) between the interest cost to finance the mortgage at these borrowing rates and the interest income received from the mortgage, but HUD did not consider the interest cost to the Government to finance the net cash flow relating to the mortgage loans. HUD also did not consider the interest cost to the Government to finance the subsidy payments estimated under section 236.

The Subcommittee requested HUD also to consider the effect of Federal income taxes that would be paid under the two methods of financing. The taxes in question are those taxes that would be paid to the Government by investors as a result of income earned on Government securities and privately financed mortgages. HUD did not consider the effect of these income taxes in its computation of the Government's financing costs. These omissions, however, did not affect HUD's conclusion.

TENANT INCOMES AND RENTS

HUD computed the average income of tenants at each of the three section 202 projects at the time of the analysis and compared the average monthly rents paid by the tenants with the basic rents that would have been paid if these projects were financed under the section 236 program. Although a tenant's income could affect the amount of rent he pays in a section 236 project, it would have no effect on rents in a section 202 project

Section 202 rents are based on the monthly revenue required to pay loan principal and interest installments and project operating expenses and to provide funds for a reserve for repair and replacement of capital items. Also HUD, as an added safety factor in establishing monthly rates, requires that the monthly revenue be based on a 95-percent-occupancy rate, because 100-percent occupancy may not be realized.

Section 236 basic rents are based on the monthly revenue required to pay loan principal and interest installments, assuming a 1-percent loan; project operating expenses; and a replacement reserve for certain capital items. HUD also considers a 95-percent-occupancy rate to be reasonable. However, a tenant must pay a monthly rent equal to the greater of (1) a basic rent or (2) 25 percent of his income. The monthly rent may not exceed the fair-market rent.

For its analysis HUD added $6 to the average monthly rents for the Fort Myers and Oak Brook section 202 projects. The increase, according to HUD, reflected an increase in operating expenses experienced in the section 202 projects. This increase, however, was not being charged to the tenants. In its report to the Subcommittee, HUD indicated that there was no basis for assuming that the projects' operating expenses would be different under either program

HUD's comparison of average monthly rents paid by tenants at the three section 202 projects and the estimated basic rents these tenants would be required to pay under section 236 is shown in the following table

	Efficiency apartment Section 202	236	One-bedroom apartment Section 202	236
District of Columbia	$ 95	$ 82	$118	$107
Illinois	130	124	141	135
Florida	93	78	113	95

As shown above, HUD estimates that tenants would pay less rent at the three projects had they been financed under section 236

GAO evaluation

As discussed previously, HUD's use of comparable projects to estimate section 236 development costs did not result in a valid estimate of what these projects would have cost under section 236 criteria and therefore affected the computation of the tenants' rents payable under section 236.

CHAPTER 3

GAO'S COMPARATIVE COST ANALYSIS

We believe HUD's comparison does not fairly present (1) the section 236 development costs for each of the three projects, (2) the Government's financing costs for each of the three projects under the two methods of financing, and (3) the tenant rents which would result from application of section 236 criteria. We have recomputed these items. An explanation of the bases used in our computations and our analyses follows.

COMPARATIVE DEVELOPMENT COSTS

We computed the estimated section 236 development costs for the three projects used in HUD's analysis on the basis that planning, land, and construction costs, except interest costs incurred during the construction period and architectural and engineering fees, would be the same as the costs incurred under section 202. (See pp. 13, 14, and 16.) The only other variables in our computation were those costs which differed under the section 202 program, such as mortgage insurance premiums, financing fees, and other HUD fees.

The following schedule compares development costs of the three section 202 projects with the costs which, we believe, would have been incurred if these projects had been financed under section 236.

	District of Columbia	Illinois	Florida
Section 236	$1,615,378	$2,392,285	$2,606,185
Section 202	1,520,000	2,201,665	2,440,000
Difference	$ 95,378	$ 190,620	$ 166,185

We estimated that section 236 development costs would exceed section 202 development costs for each project.

GOVERNMENT'S FINANCING COSTS

For purposes of our analysis, we used the section 202 development costs subject to long-term financing that were used in HUD's analysis. For section 236 development costs, we used the estimated costs shown above, which, we believe, would have been incurred if the section 202 projects had been financed under section 236. The loan amounts subject to long-term financing under each program are equal to 100 percent of project development costs. Our comparison is based on financing section 236 loans over their usual 40-year terms and section 202 loans over their usual 50-year terms. In accordance with the instructions contained in the Subcommittee's letter to HUD, interest subsidy outlays for section 236 projects were based on privately financed loans having interest rates of 7 percent.

We believe that, because the value of a series of future payments is less than a lump-sum payment made today, the application of the "present value" method in the computation of long-range costs would be more meaningful and more responsive to the Subcommittee's request. Under the present-value method, the current values of fund flows over a specific period of time are calculated using a discount rate. The discounting of future costs makes them comparable to present costs; i.e., to the present value of costs. For example, the present value of a loan of $1 million made today is $1 million. However, the present value of $1 million in subsidy payments to be made in equal annual installments over a 5-year period, assuming a discount rate of 5 percent, is about $784,000. Therefore the present-value method, in effect, considers the current worth of a series of payments in the future.

The procedure for carrying out a present-value analysis is to (1) determine the net flows in each future period (month, quarter, year, etc.) for each method of financing, (2) use a discount rate to determine the present value of the flows in each future period for each method of financing, (3) add the present value of the flows for each method of financing, and (4) compare the present values to find which method of financing has the lowest present value--the least cost in terms of the current value of future outlays.

For purposes of our analysis, we calculated costs to the Government under the present-value method, using discount rates of 5, 6, and 7 percent that are equal to the Government's borrowing rates that the Subcommittee requested be used. We also calculated the present value of Federal income tax recoveries under both programs, to determine the net cost to the Government to finance each program. We estimate that the Government's tax-recovery rate on interest paid to investors in Government securities and privately financed loans would be equal to about 4.5 percent of the interest.

The following calculation, using a discount rate of 5 percent for the Washington project, illustrates the present-value method of calculating the Government's cost for the section 202 loan and the section 236 interest subsidy alternatives.

Present Value Method Of Calculating Government Costs

	Washington	
	Section 202 loan	Section 236 subsidy
	(000 omitted)	
Mortgage amount	$1,520	$1,615
Discount rate of 5 percent		
Present value of Government payments on borrowed funds	$1,520	
Present value of loan repayments to Government by project sponsor	-1,079	
Present value of Government subsidy payments	-	$1,322
Present value of Government costs before recovery of Federal income taxes	441	1,322
Present value of Federal income taxes recovered	-43	-62
Present value of Government costs after recovery of Federal income taxes	$ 398	$1,260

Our calculation of the present value of comparative long-range costs to the Government under section 202 and section 236 financing for each of the three projects included in HUD's analysis is summarized in the following table.

Present Value Of Government Costs
Under Section 202 and Section 236

	Washington Section		Illinois Section		Florida Section	
	202	236	202	236	202	236
	(000 omitted)					
Discount rate of 5 percent						
Present value of costs before tax recoveries	$441	$1,322	$ 640	$1,958	$ 709	$2,134
Present value of costs after tax recoveries	398	1,260	577	1,866	639	2,033
Discount rate of 6 percent						
Present value of costs before tax recoveries	589	1,159	853	1,717	945	1,871
Present value of costs after tax recoveries	542	1,105	785	1,636	870	1,783
Discount rate of 7 percent						
Present value of costs before tax recoveries	705	1,027	1,021	1,522	1,131	1,658
Present value of costs after tax recoveries	655	979	949	1,450	1,052	1,580

The above table shows that, for each of the three projects, the Government's cost of providing interest subsidies under the section 236 program consistently exceeds the Government's cost of providing the mortgage loans under section 202 at discount rates of 5, 6, and 7 percent. However, as the discount rate increases from 5 to 7 percent under the present-value method the cost differential between the two financing methods decreases. Section 236 costs will consistently exceed section 202 costs when the private borrowing rate exceeds the Government's borrowing rate. Historically, private borrowing rates consistently have exceeded Government borrowing rates. A report prepared by the Council of Economic Advisors in October 1971 shows, for example, that, during the period from 1963 to September 1971, yields on U.S. Government securities ranged from about 1.1 to 4 percent less than yields on loans insured by HUD at the maximum permissible interest rates.

TENANT INCOMES AND RENTS

We compared the average monthly rents which, HUD reports, are being paid in the section 202 projects with the basic monthly rents which, we believe, would have been payable if these projects had been financed under section 236. Our estimates of section 236 rents are based on monthly project revenue requirements that consider those project development costs which, we believe, would have been incurred under section 236. (See p. 24.)

The following table compares, for the three projects, average monthly rents under section 202 with basic monthly rents payable under section 236.

	Efficiency apartment		One-bedroom apartment	
	Section		Section	
	202	236	202	236
Washington	$ 95	$ 86	$118	$114
Illinois	130	120	141	131
Florida	93	79	113	96

Although the average section 236 basic rents would be lower than the average section 202 rents, a tenant in a section 236 project must pay a monthly rent equal to the greater of either a basic rent or 25 percent of his monthly income. The monthly rent may not exceed the fair-market rent for the project. We reviewed the reported incomes of tenants at each of the three section 202 projects to determine what rents they would pay.

In the Washington project five tenants of one-bedroom apartments would have been required to pay more than the basic rent. For three of these tenants, the rents payable--ranging from $120 to $150--would exceed the average section 202 rent of $118. No tenants were affected by this provision in the Illinois project. In the Florida project 24 tenants of efficiency apartments and 16 tenants of one-bedroom apartments would have been required to pay more than the basic rent. For five tenants of efficiency apartments, the rents payable--ranging from $94 to $106--would exceed the average section 202 rent of $93.

However, for most of the tenants of the three projects, rents would be lower under the section 236 program because their incomes generally were not high enough to require payment of rents which would exceed the section 236 basic rents.

CONCLUSIONS

HUD's selection of the three section 202 projects in the District of Columbia, Illinois, and Florida was responsive to the Subcommittee's request that three recently constructed and operational projects, of different sizes and in different geographic locations, be used as the basis for the comparative cost analysis.

We do not agree with HUD's analysis which showed that project development costs might be higher under section 202 than under section 236. Instead, project development costs under section 202 would be lower than under section 236 because of the inclusion of those costs peculiar to the section 236 program, such as higher interest costs during construction, mortgage insurance premiums; examination, inspection, and financing fees; and certain other fees.

Although our approach and HUD's approach to estimating Government financing costs differed, we agree with HUD's analysis which showed that the long-range costs to the Government to provide the interest subsidy under section 236 financing would exceed the long-range costs to the Government to provide the low-interest loans to sponsors of section 202 projects.

We also applied different bases than those used by HUD in estimating rents payable under section 236; however, we agree with HUD's analysis which showed that tenants' rents generally were lower under section 236 than under section 202.

COPY

UNITED STATES SENATE

SPECIAL COMMITTEE ON AGING

(PURSUANT TO S RES 27, 92D CONGRESS)

WASHINGTON, D C 20510

July 22, 1971

Honorable George Romney
Secretary
Department of Housing and
Urban Development
Washington, D C

Dear Mr Secretary

The Department of Housing and Urban Development decided that, effective July 1, 1970, applications for loan assistance in providing housing for the elderly would be considered for assistance under the interest subsidy program, authorized by section 236 of the National Housing Act, rather than under the direct loan program, authorized by section 202 of the Housing Act of 1959

To evaluate the impact of the Department's action on the elderly tenants of projects and on the Government, the Subcommittee requests that your Department furnish the Subcommittee with a comparison of (1) the costs related to the planning, construction, and operation of selected projects by nonprofit organizations under the section 202 and section 236 programs, and (2) the costs to the Government to finance housing for the elderly under each of the two programs

In comparing the various cost elements of a project constructed under either of the two programs, the Subcommittee requests that three recently constructed and operational section 202 projects, of varying size and geographic location, which are considered to be typical of the projects authorized under the section 202 program, be used as the basis for the comparison All significant variances in planning, construction, and operating costs resulting from application of the section 236 program criteria should be explained It is requested also that a comparison be made of project rents under each program, using as a basis for computing section 236 rents, the income reported by the tenants of each section 202 project

With respect to the comparison of the costs to the Government to finance housing for the elderly under the two programs, it is requested that such costs be computed, for each selected project, on the basis of the net cash flow of funds, using (1) the capital sum provided by the Government loan at 3 percent under the section 202 program, and (2) the estimated capital outlay of the Government using private financing with part of the interest cost paid by the Government under the section 236 program Interest subsidy costs should be computed on the basis that interest on private financing is at the current maximum rate (7 percent) permissable for section 236 projects For purposes of the calculations, an assumption should be made that all Government funds required to finance the loan and interest subsidy outlays are obtained from Treasury borrowings with interest at the rates, alternatively, of 5, 6, and 7 percent

Administrative costs of the Government related to the two programs should be included as part of the capital outlay in the calculations if such costs are relatively significant in comparison with the capital investment and interest costs In addition, appropriate consideration should be given to the Federal income taxes that would be paid under the two methods of financing

The Subcommittee would appreciate the results of the above comparisons by September 15, 1971

Sincerely,

Harrison A Williams, Jr
Chairman, Subcommittee on
Housing for the Elderly

COPY

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

FEDERAL HOUSING ADMINISTRATION

WASHINGTON, D.C. 20411

OCT 1 1971

Assistant Secretary-Commissioner

Honorable Harrison A Williams, Jr.
Chairman, Subcommittee on Housing
for the Elderly
Special Committee on Aging
United States Senate
Washington, D.C. 20510

Dear Mr Chairman

This is in further reply to your July 22, 1971, request for a comparison of costs relating to the Section 202 and Section 236 programs.

In order to develop the data requested, we chose three recently completed Section 202 projects of various sizes in different geographical locations. The Section 202 projects are as follows SH-DC-02,100 units, Washington, D.C.; SH-FLA-41, 180 units, Fort Meyers, Florida; and SH-ILL-18, 150 units, Oak Brook, Illinois. A breakdown of actual costs incurred in developing these Section 202 projects is compared with estimated costs based on Section 236 processing instructions. As exhibited in Appendix (A), the mortgage amount under Section 202 exceeds the estimated mortgage amount of the Section 236 projects except for the Illinois case. Several factors contribute to the differences found in (A).

(1) Planning expenses are approximately equal in the Florida comparison. The Chicago Section 202 case is higher than the Section 236 primarily because a consultant's fee was included in the Section 202 processing but, due to the sponsor's previous experience, the exclusion of such an allowance was warranted in Section 236 processing.

(2) Land costs actually incurred were accepted for Section 236 processing.

(3) Construction costs are higher in the Florida and Washington, D.C. Section 202 cases perhaps due to differing program practices. FHA construction estimates are based on allowable comparable construction costs in the area. Section 202 construction costs are based on competitive bidding. The competitive bid procedure not only relies on experience but may also include an allowance for projected construction cost rates.

The Section 202 Illinois case had a lower construction cost due to the special construction techniques used in that case The FHA estimate was not based on comparable stressed concrete construction as no such comparable data are available. Therefore, any savings resulting in such construction techniques were not reflected in the Section 236 cost estimate

Architectural and engineering fees are lower under FHA 236 than under Section 202 Such costs under FHA are subject to an established fee schedule Under Section 202, fees are allowed based upon local American Institute of Architects rates which in most instances are higher than the FHA fee schedule

(4) The "other" category of expenses is higher in all Section 236 projects as this item reflects financing fees, mortgage insurance premiums during construction, FHA processing fees, and generally a larger nonprofit contingency allowance

With regard to the operational expenses of both types of housing, Section 202 estimates were considered adequate for Section 236 in the Washington, D.C. case However, in the Illinois and Florida cases $6 per unit per month was added to the Section 236 rents to raise operating expenses to a level actually being incurred by the Section 202 project

There is no basis for assuming that a new case processed under Section 202 would have different operational expenses than a comparable Section 236.

Administrative costs of the program are not considered to have a significant effect on either program's overall cost to the government. However, it should be noted that FHA collects a one time fee under Section 236 amounting to $8.00 per thousand dollars of the mortgage amount which virtually offsets FHA administrative costs The Section 202 program employs no such offset to administrative costs.

The deeper subsidy provided by the Section 236 program generally results in significantly lower subsidized rental than those found in counterpart Section 202 developments (See Appendix B) Most of the tenants' incomes are sufficiently low that they would be required to pay "basic" rents under the Section 236 program.

The comparative long-range costs to the government are shown on the two tables of Appendix C Table 1 compares the three cases assuming a forty year mortgage for both 202 and 236, while Table 2 assumes a fifty year mortgage for both programs. The same number of years was selected under both programs to provide the basis for comparison suggested at the Subcommittee hearing, even though the 236 mortgage is typically forty years, while the 202 mortgage is typically fifty years. Both tables assume a 236 mortgage rate of 7 percent. In addition, since the method for computing the long range cost of a 202 mortgage (which is described below) depends upon the government borrowing rate, costs have been computed at government borrowing rates of 5 percent, 6 percent and 7 percent. It should be noted that the current average long term government borrowing rate is approximately 6 percent.

The methods for computing these long range costs are as follows

(1) 202 - The difference between financing the mortgage at the government borrowing rate and financing the mortgage at 3 percent.

(2) 236 - The sum of the subsidy payments for the life of the mortgage assuming a subsidy payment which is 97 percent of the maximum. This assumption, based on a limited review of Section 236 elderly projects, means that some tenants would pay more than "basic" rental.

(3) The cost of compounding the interest expense in financing the difference between the 3 percent Section 202 (50 yr.) mortgage and the assumed government rate of borrowing and the interest expense in financing the Section 236 (40 yr.) subsidy was not calculated. If such a calculation were made, Section 202 long range costs would more closely approximate Section 236 long range costs.

No attempt was made to evaluate the net effect on Section 236 costs of including the FHA Mortgage Insurance Premium in the subsidy computation. The inclusion of FHA MIP in Section 236 cases raises the subsidy costs to the government and at the same time tends to offset potential losses due to defaults As you know, the Section 202 program has no such feature

In addition, the Section 236 subsidy formula provides for a decreasing subsidy to the extent that tenant incomes increase faster than operating costs Although we do not expect this characteristic to result in significant subsidy savings in Section 236 elderly projects, it is noted that the Department estimates that nonelderly Section 236 projects may not need any subsidy after 22 years.

Since our analysis was confined to nonprofit sponsors of Section 202 and Section 236 housing developments, we do not believe that there would be significant differences in Federal income tax collections between the two methods of funding.

Sincerely,

Eugene A. Gulledge

Enclosure

APPENDIX A

COMPARATIVE DEVELOPMENT COSTS OF SECTION 202 AND SECTION 236 PROJECTS

	Planning 1/	Land 2/	Construction 3/	Other 4/	Total
	$	$	$	$	$
D. C.					
Section 202	43,625	110,000	1,362,200	4,175	1,520,000
Section 236	25,800	110,000	1,151,924	107,905	1,395,630
Illinois					
Section 202	35,766	60,000	2,105,899	--	2,201,665
Section 236	14,000	60,000	2,290,360	176,701	2,541,061
Florida					
Section 202	56.783	142,000	2,213,138	28,077	2,440,000
Section 236	57,787	142,000	1,835,818	154,395	2,190,000

1/ Planning (pre-construction)· preliminary expenses; organization and development, legal and administrative expenses.

2/ Land Cost

3/ Construction phase construction, architect fee, engineering fee, resident inspector, interest during construction and development, insurance and taxes during construction.

4/ Other: title and recording fee, financing fee , FHA examination fee, mortgage insurance premium, FNMA fee, contingency.

APPENDIX B
INCOME AND RENTS UNDER SECTION 202 AND SECTION 236

	D. C.		Fla.		Ill.	
	Aver. Income	Rent	Aver. Income	Rent	Aver. Income	Rent
Section 202						
Efficiency	$2,850	$ 95	$3,204	$ 93 1/	$3,711	$ 130 1/
One Bedroom	3,600	118	4,142	113 1/	4,390	141 1/
Section 236						
Efficiency	2,850	82	3,204	78	3,711	124
One Bedroom	3,600	107	4,142	95	4,390	135

1/ An upward adjustment of $6.00 per unit per month was made due to increased operating experienced in Section 202 cases. This increase makes the operating expense estimates comparable for Section 236 and Section 202 examples cited above.

APPENDIX C

Table 1 - Long Range Cost to Government, 40-Year Mortgages
(In thousands of dollars)

Example	236 1/	202 2/ Government Borrowing Rate 3/ 5%	6%	7%
D. C.	$2,664	$ 908	$1,404	$1,924
Illinois	4,851	1,315	2,033	2,786
Florida	4,181	1,457	2,254	3,088

Table 2 - Long Range Cost to Government, 50-Year Mortgages
(In thousands of dollars)

Example	236 1/	202 2/ Government Borrowing Rate 3/ 5%	6%	7%
D. C.	3,355	1,206	1,865	2,551
Illinois	6,109	1,747	2,701	3,695
Florida	5,265	1,936	2,994	4,096

1/ The sum of the subsidy payments for the life of a 7% mortgage assuming a subsidy payment which is 97% of the maximum. This assumption means that some tenants would pay more than the "basic" rental.

2/ The difference between financing the mortgage at the government borrowing rate and financing the mortgage at 3%.

3/ The approximate average long term government borrowing rate is currently 6%.

4/ These calculations do not take into account the distinct possibility that Elderly incomes may rise resulting in the reduced interest reduction payments over the life of the mortgage.

U S. GAO Wash , D C