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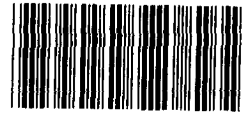
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Potential Losses from the Rental Housing Inventory: Soundness of Current Estimates

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Before the
Subcommittee on Housing
and Community Development
Committee on Banking, Finance
and Urban Affairs
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

I am very pleased to be here today to discuss GAO's efforts to measure potential losses in federally subsidized units from low- and moderate-income rental housing. My testimony today is based on a study that GAO is currently conducting at the Subcommittee's request. The results I report are preliminary and subject to revision as we complete our work.

OVERVIEW OF OUR HOUSING STATISTICS STUDY

In recent years, several studies have suggested that a large number of federally subsidized units could be lost from the low- and moderate-income housing inventory as private owners end their participation in federal housing programs by prepaying their mortgages. Losses from the more than 600,000 units supported by mortgage insurance and interest subsidies under the section 221(d)(3) and section 236 programs have been estimated at more than 300,000 early in the next century; for some other programs, the numbers are even higher. This potential loss of existing low- and moderate-income housing poses a serious policy problem, given that little new housing of this type has been constructed over the last few years.

Background on federal housing programs

Federal housing assistance for low- and moderate-income families changed dramatically after the passage of the Housing Act of 1937. Initially, the federal government, working through local public housing authorities, assumed primary responsibility for meeting the goal of "a decent home and a suitable living environment for every American family," as enunciated in the Housing Act of 1949. Beginning in the 1950's, however, this responsibility began to shift to the private sector through a series of programs designed to provide federal mortgage insurance and interest-rate subsidies to reduce the financing costs of new construction. During the 1960's rent subsidies were added to the support for the private development and operation of low- and moderate income housing. In the 1970's and 1980's these subsidies were changed from project-based to tenant-based programs, culminating in the introduction of vouchers in 1983.

In our work, we focus on the low- and moderate-income housing developed under sections 221(d)(3) and 236 of the Housing Act, as amended. Under these programs, the Federal Housing Administration insures 40-year mortgages on the covered properties. Initially, the loans were made under section 221(d)(3) at the prevailing market interest rate (MR), but a 1961 amendment provided for below-market interest rates (BMIR) of 3 percent through federal subsidies paid up front. In 1968, this was replaced by monthly subsidies to reduce the interest rate under section 236 to 1 percent. In return for the mortgage insurance and interest-rate subsidies, the owners of these

projects agreed to restrict the use of the units to low- and moderate-income households.

Threats to the subsidized inventory

Over the past few years, a major concern of the Congress, as exemplified by the emphasis at this hearing, has been that owners of section 221(d)(3) and section 236 properties generally have an option to prepay their mortgages at the end of 20 years, rather than holding them for the full 40-year term. In many cases, such prepayment would remove the use restrictions that keep the property available for low- and moderate-income renters. The properties could then be used for other purposes, such as market-rate rentals, condominium conversions, or even commercial properties.

The ability to prepay and convert the property is limited in several ways. First, projects owned by nonprofit or public sponsors and those owned by for-profit owners who purchased them from nonprofit owners remain subject to the use restrictions for the entire 40 years of the original mortgage, unless the Secretary of the Department of Housing and Urban Development (HUD) specifically approves the prepayment and lifting of use restrictions. In addition, for-profit sponsors whose projects have received rent supplements or flexible subsidies must maintain their properties as low- and moderate- income rental units for the life of the original mortgage. Under these circumstances, concerns about prepayment among these owners are minimal.

However, many other owners, for-profit sponsors who are not affected by the restrictions mentioned above, appear to be eligible to prepay and convert their properties to presumably more lucrative uses in the next few years. Some of these owners may not be able to end use restrictions immediately, because they also have section 8 subsidies that require that the properties be used for low- and moderate-income rentals throughout the life of the section 8 agreements. But for many such properties, the section 8 agreements will end during the first half of the 1990's.

The major reasons why property owners might choose to prepay revolve around the potential for higher profits if the properties are put to other uses. Currently, profits in these programs are limited to a pretax return of 6 percent annually on the original equity investment, usually a down payment amounting to 10 percent of the project cost. This could mean that pretax profits from these projects are rather modest, given the overall change in prices over the past 20 years. But after-tax returns could be much higher, because mortgage payments in the early years of the mortgage would go largely for tax-deductible interest, and generous depreciation rules have already allowed much of the cost

of the property to be written off. However, by the 20-year point, many of these projects no longer benefit from these tax provisions, because mortgage payments are largely for nondeductible principal payments, and often the depreciation has been fully taken.

In 1987, the Congress addressed the prepayment problem temporarily by requiring that HUD be notified of an owner's intent to prepay and that, in all prepayment cases, the owner develop a plan of action, acceptable to HUD, to deal with the effects of prepayment on low- and moderate-income households. These restrictions, effectively providing a moratorium on prepayments, are scheduled to expire on September 30, 1990. The major issue now confronting the Congress is whether action is necessary to prevent the loss of housing units through prepayments and what such action should be. To answer these questions, information is needed on the likely scope of the prepayment problem.

OUR STUDY AND FINDINGS

To help address this concern, we were asked to review the estimates of possible losses to low- and moderate-income housing to determine the soundness of the methods the researchers used and the reasonableness of the estimates of loss they reported. In conducting this review, we used bibliographic data bases and the advice of a panel of experts to identify studies that address the potential loss of low- and moderate-rental housing. We found only four studies that presented original estimates of potential losses in the subsidized low- and moderate-rental housing universe. Three of these were conducted by government agencies: GAO, the Congressional Budget Office (CBO), and HUD. The fourth was carried out by the National Low Income Housing Preservation Commission, a private concern financially supported by the National Corporation for Housing Partnerships and the Ford Foundation.

In addition, we gathered information on experience up to now with prepayments under the Housing and Community Development Act of 1987. We found that by December 31, 1989, only 92 property owners had notified HUD of their intent to prepay. Of these, 45 had filed plans of action, 7 of which HUD had approved for incentives. In no case had an owner actually been allowed to prepay. Thus, little is known about the actual effect of prepayments on the properties or tenants involved.

Finally, during the autumn of 1989, we interviewed housing officials, market experts, and property owners in four cities to collect information on the likely effect of local market factors on prepayment decisions. Two of the cities, Boston and Los Angeles, are "tight" markets, where demand for low- and moderate-income housing is high relative to supply (although there has

been some softening of the Boston market in recent months), while the two others, Denver and Houston, have demand that is low relative to supply.

Findings on prepayment estimates

With respect to our analysis of the four studies, two of them--those by CBO and GAO--assumed that all owners would prepay when they can.[1] Both HUD and the Preservation Commission made estimates of the probable losses that might be expected from the insured low- and moderate-income housing inventory. As one would expect, their estimates are lower than the CBO and GAO estimates, which aimed at providing figures on the maximum losses that might be expected.

Table 1 shows that the four studies provide a wide range of estimates of the inventory covered by sections 221(d)(3) and 236, ranging from 581,000 to 645,000 units. This results from some technical differences in how the data were extracted from HUD's data bases and the exclusion of section 221(d)(3)-MR properties from the CBO study.

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[1]The GAO study also included an estimate of the minimum potential losses. This estimate was 6,000 units by 2005, assuming all owners held their mortgages for the full term.

Table 1: Estimated Prepayments Under Sections 221(d)(3) and 236[a]

	Preservation Commission (1988)	HUD (1986)	CBO (1987)	GAO (1986)
Total Inventory	645	604	581[b]	627
Eligible to prepay	367	364	334	425[c]
Projected prepayments by 2005				
Maximum	not proj.[d]	not proj.[d]	334	255
Probable	243[e]	154[f]	not proj.[d]	not proj.[d]
Maximum and probable prepayments as % of total inventory	38	25	57	41

[a]In thousands of units.

[b]Excludes section 221(d)(3)-MR properties.

[c]Includes some properties that could prepay but would still be subject to use restrictions because of rent supplementsor flexible subsidies.

[d]Not projected.

[e]Estimate of the National Low Income Housing Preservation Commission is for prepayments by 2002.

[f]HUD estimate is for prepayments "ever."

Source: National Low Income Housing Preservation Commission, Preventing the Disappearance of Low-Income Housing (Washington, D.C.: 1988); testimony by Thomas Demery, Assistant Secretary for Housing and Federal Housing Commissioner, before the House Subcommittee on Housing and Community Development (October 21, 1986); Congressional Budget Office, The Potential Loss of Assisted Housing Units as Certain Mortgage-Interest Subsidy Programs Mature (Washington, D.C.: March 1987); U.S. General Accounting Office, Rental Housing: Potential Reduction in the Privately Owned and Federally Assisted Inventory, GAO/RCED-86-176FS (Washington, D.C.: June 1986).

However, three of the studies had similar estimates of the number of units eligible to prepay, 334,000 to 367,000 (the larger GAO estimate includes specific for-profit properties with rent subsidies and flexible subsidies that can prepay but would still be subject to use restrictions). The importance of this broad agreement on the number of units eligible for prepayment is that it provides an approximate upper limit to the scope of the prepayment problem. That is, it appears that at most about 367,000 units could be lost from the inventory through prepayments.

The estimated losses in these programs by early in the next century range from 154,000 to 334,000 units. At the high end, CBO estimated that, by 2005, all the 334,000 units eligible to prepay could do so, representing about 57 percent of the total. At the low end, HUD concluded that of 364,000 units eligible to prepay, 84,000 "definitely" would prepay and an additional 70,000 "likely" would do so, for a total of 154,000 units, or about 25 percent of the total inventory. The Preservation Commission's analysis predicted that by the year 2002, a total of 243,000 units (38 percent) would be lost, a figure similar to GAO's estimate of a maximum of 255,000 units (41 percent of the inventory) by 2005.

These differences largely reflect the methods that were used to generate the estimates. As I noted earlier, CBO and GAO assumed all eligible units would prepay when able to do so to arrive at their maximum estimates; differences between their estimates largely reflect different assumptions about the effect of related subsidy arrangements. In contrast, HUD asked loan-service officers in each region to fill out a questionnaire on the financial and physical condition of each property in the inventory and then to reach a judgment on the likelihood that each would prepay. The Preservation Commission developed a model of the factors likely to affect owners' prepayment decisions and collected data on a sample of 300 properties, to apply to the model, from HUD, housing market experts and the property owners.

Although both HUD and the Preservation Commission made serious efforts to estimate probable losses, we believe that there are problems with both studies. The HUD method of relying on loan-service officers' opinions of whether specific properties were likely to prepay at any time over the term of the 40-year mortgage seemed particularly weak, especially given that consistent criteria were not specified. The Preservation Commission's model was a far more useful analytical tool, but as with most such models, its predictions are subject to error from uncertainty about important parameters (for example, the projected rate of inflation), variables omitted from the model, and, of course, unforeseen events. Moreover, the data the Preservation Commission used were based on only 198 properties eligible to prepay, a sample size far too small to account for

differences among housing markets. (See the appendix for a more thorough discussion of the HUD and Preservation Commission methodologies.)

Findings from our case studies

Our interviews with housing officials, market experts, and owners of section 221(d)(3) and section 236 properties in Boston, Denver, Houston and Los Angeles point to the importance of local market conditions in prepayment decisions. We interviewed property owners eligible to prepay by September 30, 1994--that is, within about 5 years of the date of the interview. These owners included about 60 percent of those eligible to prepay in Denver and Houston and a judgment sample of about one third of those in Boston; in Los Angeles, the large number of owners meeting our selection criteria meant that our judgment sample was only about 6 percent of those eligible. Our interviews were intended to be illustrative, and not to provide nationally-representative estimates of owners' plans.

In the tight housing markets Boston and Los Angeles, all but one of the owners we interviewed would like to prepay as soon as possible. Our analysis of owner responses showed that current market value and built-up equity outweighed all other factors in these decisions. As a result of the rapid appreciation of property values in these areas over recent years, the owners' equity in the properties has increased significantly. We found that, in most cases, the built-up equity is so great that even substantial conversion costs will not dissuade these owners from converting the property to market-rate housing.

Owner responses in the low-demand markets Denver and Houston were markedly different: none of the owners indicated they planned to prepay. In both cities, relatively low rents and high vacancy rates in the general housing market disposed owners not to prepay the mortgage and convert the property to market uses. In general, the owners we interviewed told us subsidies such as HUD's section 8 program provide guaranteed rent revenue and occupancy for their properties. For example, in the Denver properties we examined, 325 of the total of 418 units received section 8 loan management set-aside funding. The owners' responses showed that the average vacancy rate for these properties is estimated to be approximately 3 percent, far below the overall Denver housing market figure of 10 to 12 percent. In addition, the cost of conversion coupled with the uncertainties of operating in the general market appear to be factors in owners' decisions against prepayment in these markets.

Thus, our findings suggest that the prepayment problem is closely tied to the opportunities available to property owners in the local market. This means that the extent of the problem may vary widely from city to city.

CONCLUSIONS

Overall, we conclude that consistent estimates of the maximum loss of low- and moderate-income insured rental units through mortgage prepayments are available, based on reasonable agreement about the size of the total inventory and about the number of units that are eligible for prepayment. However, estimates of probable losses are uncertain. Under these circumstances, if the Congress wants to avoid the loss of low- and moderate-income housing units, two broad responses may be appropriate.

First, the Congress could decide to aim preservation efforts at all the approximately 367,000 units eligible to prepay. This strategy would recognize that there is, after all, an upper limit on the number of units eligible for prepayment and that while the probable number of prepayments is hard to predict accurately, all current predictions suggest that many of the eligible units will prepay. Precise efforts to prevent prepayment could involve increasing the current profit limits under sections 221(d)(3) and 236 through some combination of (1) tax credits, (2) changes in the basis on which profit levels are computed (for example, making the basis current appraised value rather than original equity investment), or (3) other incentives. The disadvantage of using tax credits is that it involves losses in federal revenues. Changing the basis for computing profits, however, has the disadvantage of being likely to increase rents to tenants and costs to the federal government through increases in rental assistance to those tenants.

Of course, if this approach is adopted, some owners who would not have prepaid in any case will receive windfall benefits. But this cost may be partly offset by the likelihood that some owners who might have defaulted would not do so.

An alternative strategy, however, would be to recognize that, to some extent, the prepayment problem is closely tied to prevailing conditions in specific local housing markets. Using this strategy, the Congress could extend incentives to owners of low- and moderate-income housing projects that incorporate a flexible approach based on local housing market conditions. That is, HUD could be directed to continue, much as it does now, offering incentives in selected areas case by case, taking account of the appraised value of the property, the costs of conversion to other uses, the demand for rental or condominium units in the local market, and other such factors. This means that more assistance might be needed in tight housing markets than in those where demand is low relative to supply and also that the level of assistance in any given market might change as market conditions change.

This strategy has the advantage of being potentially less costly than offering incentives to all eligible owners. It accords with our findings that in relatively low-demand markets, most owners benefit from the virtually guaranteed cash flow and relative protection from market risks afforded by participation in the assisted-housing programs and are, therefore unlikely to convert their buildings to other uses or to be able to sell them as a way of extracting built-up equity.

But to make such a strategy work, HUD will need to improve its collection and maintenance of information on the properties covered by these programs. More importantly, close management and careful oversight would also be needed. But the fact that incentives would be offered in limited numbers of cases should simplify management oversight. In addition, HUD's experience with using current incentives to address the prepayment issues should prove useful in optimally targeting the effort.

While alternative uses of some eligible properties would be so attractive financially that HUD would not be able to offer adequate incentives to retain them among low- and moderate-rental housing, no other plan would prevent this situation, either. Of course, the moratorium on prepayments could be made permanent, but it is also possible that either legal challenges or owners' actions (such as refusal to maintain the property or massive numbers of defaults) would make any blanket continuation of these restrictions impractical.

This concludes my prepared statement, Mr. Chairman. I will be happy to respond to any questions that you or members of the Subcommittee may have.

APPENDIX

THE METHODS OF HUD AND THE PRESERVATION COMMISSION FOR ESTIMATING PROBABLE LOSSES

As I discussed in the text, only the HUD and Preservation Commission studies attempted to derive estimates of the probable losses that could be expected from prepayment actions. Both of these studies used methods with serious problems.

HUD'S ESTIMATES

HUD in its study, presented in congressional testimony in March 1987, estimated that about 154,000 units (25.5 percent of HUD's inventory of Sections 221(d)(3) and 236 units) would "ever" be probable losses from prepayment. Further, HUD concluded that 75 percent of the losses would occur in three of its regions. HUD concluded that this number of units at risk in a few locations would not create the crisis that was feared by many housing experts.

To develop this estimate of the probable number of prepayments, HUD directed each of its field offices to determine the properties under its jurisdiction that were either likely or unlikely to prepay their mortgages. We believe that the method HUD used to predict these losses is seriously flawed methodologically. First, HUD's effort is based on opinion. The judgments of HUD's loan-service officers, based on their own records and knowledge of the properties, were the sole source of information on likely prepayments. But no consistent criteria for judgment were prescribed, making it impossible to know whether other loan-service officers would have reached the same opinions.

Second, in reviewing the questionnaire used to make these estimates, we found that it lacked many key financial indicators, such as market value and alternative uses, cost data on needed repairs and improvements, and whether the local real estate market and individual property's financial situation is such that conversion costs are prohibitive. However, there were questions about other relevant factors, such as proximity to downtown or to schools, parks, libraries, and playgrounds. Questions about negative neighborhood amenities and safety were also addressed.

Third, no information was gathered from property owners regarding their intentions, possible alternative uses for the property, or its financial and physical conditions. The opinions queried were those of government loan-service officers, not those of the most relevant population, private owners.

Fourth, we found significant problems with the data HUD loan-service officers used to make their estimates. We

interviewed HUD field and regional office loan-service officers on selected properties in Boston, Denver, Houston, and Los Angeles. We designed these interviews to learn about the property-specific data that HUD field offices have and about how much loan-service officers know about their assigned properties. We found a wide variation in the amount of property-specific data available from location to location. For example, loan-service officers thought some properties were owned by for-profit interests when in fact they were nonprofit owners ineligible to prepay. Some officers had a significant amount of information about the financial condition of properties while others did not. Given their responses, we believe that the HUD officials often lacked data on property-specific real estate values and had at best vague ideas of possible alternative uses for properties.

We also found some discrepancies in the numbers reported. For example, one HUD Denver region determined that of its 145 properties (12,347 units) eligible for prepayment, as few as 15 properties (1,182 units) will likely prepay, and 79 properties (7,587 units) are not likely to prepay. For the remaining 51 properties, the region's loan-service officers responded that they did not know what the owners' likely action would be. However, HUD's 1987 report places 57 properties in the unknown category for the entire nation. This suggests that some changes may have been made after data were submitted by HUD's regional officials.

Given all these problems, we believe that HUD's estimates cannot be regarded as reliable.

THE PRESERVATION COMMISSION ESTIMATES

The consensus of experts we consulted was that the Preservation Commission's study is the best available addressing likely housing losses. The report builds on a carefully selected sample of HUD properties and uses a sophisticated modeling technique to estimate the likelihood that property owners will default or prepay their mortgages under various alternative scenarios. The sample was drawn from the older portion of the Federal Housing Administration multifamily rental inventory insured before 1975. Thus, it included properties slightly closer to the date of possible prepayment than a random sample of all properties would have produced (but only 17 percent of the properties in the universe of concern were developed after 1975). For each sample property, the Preservation Commission obtained data from HUD's files, market experts, and the property owners.

In general, we believe that the commission's approach provides a reasonable basis for making estimates of how economic factors might influence the overall likelihood of prepayments under the Section 221(d)(3) and Section 236 programs. However, several problems with this analysis limit the reliability of the

estimates generated by the model. First, the sample size for this study, 300 properties, included only 198 eligible to prepay. This sample size was too small to permit predictions about specific markets. However, our own fieldwork suggests that markets vary greatly in the extent to which they provide attractive alternative uses for properties eligible for prepayment.

Second, the model assumes no government action and therefore does not consider HUD's ongoing efforts to prevent tenant displacement. For example, it assumes that no section 8 loan management set-aside contracts will be renewed or replaced at expiration, whereas HUD currently extends these contracts. It also does not take into account state limits on use conversions that may apply to many projects.

Third, while the model examines the economic behavior of owners, it is not designed (as the study notes) to take into account other influences on owners' decision making. These include changes in local real estate markets, local politics, owners' concern about the effect on tenants, risks inherent in changing the character of the real estate, and the possibility that financial information will not always be perfect. Such limitations are usually inherent in formal forecasting models, of course.

Fourth, the model appears to be sensitive to assumptions about a number of parameters. For example, when the inflation rate is assumed to be zero, rather than 5 percent, the estimated number of units lost through prepayments drops from 243,000 to 131,000, or 23,000 fewer than HUD's estimate. Given that increases in rents may be near zero, or even negative, in some markets, this is a serious limitation on the model's predictive utility.

Thus, while the Preservation Commission's estimates may be the best available, they are subject to significant limitations. From this analysis and our own fieldwork, we believe that these problems could result in an unreliable estimate of the likely losses in federally supported low- and middle-income housing units.