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MULTIFAMILY HOUSING

HUD's Mark-to-Market Proposal

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to testify before this Subcommittee as it assesses the proposal by the Department of Housing and Urban Development (HUD) to restructure its multifamily housing portfolio, an approach known as "mark to market." About 2 million privately owned and managed rental units benefit from mortgage insurance and/or rental subsidies provided by HUD. The proposal seeks to address a variety of problems affecting projects in HUD's multifamily portfolio that both have HUD-insured mortgages and receive rental subsidies tied to units in the projects (project-based assistance) under HUD's Section 8 rental assistance program. The proposal calls for decoupling rental subsidies and mortgage insurance at individual projects and adjusting mortgage debt, as necessary, to help projects compete effectively in the commercial rental market.

Our testimony today is based on work we have carried out during the past several years on HUD's multifamily housing portfolio as well as on our preliminary analysis of HUD's mark-to-market proposal. Today we will focus on the following questions: (1) what problems affect the condition of this portfolio; (2) how does HUD believe its mark-to-market proposal would address these problems; (3) which properties will be affected by HUD's proposal; (4) what costs and savings may result from the mark-to-market approach; and (5) what key issues does the Congress face in considering the proposal?

In summary:

- HUD's multifamily housing portfolio is affected by several serious problems. In many cases HUD pays higher costs to subsidize properties than are needed to provide the households living in them decent affordable housing. In other cases, rents set by HUD are lower than required to maintain the properties' physical condition, contributing to poor living conditions for families with low incomes. These problems stem from, among other things, HUD's dual role as assistance provider and insurer and inadequate management of the multifamily portfolio by HUD, including its limited use of available enforcement tools.

- HUD recognizes these problems and is attempting to address them through its mark-to-market proposal. The mark-to-market proposal rests upon HUD's belief that the best way to eliminate excess subsidy costs and improve the poor physical condition of some of the properties is to rely primarily on market forces. Consequently, for properties that both have mortgages insured by HUD's Federal Housing Administration (FHA) and receive project-based assistance, HUD generally proposes to replace the project-based assistance with tenant-based assistance, thereby requiring the properties to compete in the market place for tenants. The proposal would also restructure mortgages for properties if such action is needed for them to remain viable without the receipt of project-based assistance.

- HUD's proposal targets about 9,000 properties with 900,000 units that have both FHA mortgage insurance and project-based Section 8 assistance. The majority of these are (1) older assisted properties that receive Section 8 assistance under HUD's loan management set-aside program or (2) newer assisted properties that receive assistance under HUD's Section 8 New Construction or Substantial Rehabilitation programs. A primary difference between the two categories of properties is that the rents in about 67 percent of the older assisted properties are less than the market rents for comparable unassisted units while rents in almost 80 percent of the newer assisted projects exceed comparable market rents.

- It is difficult to forecast the costs and savings associated with HUD's mark-to-market proposal. While HUD's proposal should result in substantial reductions in Section 8 subsidy costs, it will also trigger billions of dollars in claims against FHA's insurance fund. HUD deserves credit for attempting to estimate the costs of its mark-to-market proposal; however, its current estimates are based on a number of assumptions that may or may not prove accurate and reliable. Accordingly, in our view, these estimates may be subject to considerable error.

- The Congress faces a number of key issues in considering whether HUD's mark-to-market proposal represents the best approach for addressing the problems affecting HUD's multifamily portfolio. These include (1) the processes that should be used to restructure multifamily mortgages, (2) the speed with which the mark-to-market approach needs to be implemented, (3) the extent to which the government should finance project rehabilitation, (4) the question of whether loans should be sold with or without FHA insurance, (5) the level of protection and assistance the Government should provide to tenants after project-based subsidies are discontinued, (6) the question of how to improve the usefulness of tenant-based assistance, and (7) the extent to which projects with assisted rents below market rents should be included in the proposal.

Before discussing these topics, we would first like to briefly outline the characteristics of HUD's multifamily portfolio.

HUD'S SECTION 8 ASSISTED AND INSURED MULTIFAMILY PORTFOLIO

HUD's Section 8 program provides rent subsidies for low-income families that are linked either to property units (project based) or to individuals (tenant based). According to HUD's data, the Department's Section 8 multifamily portfolio includes about 1.5 million rental units in approximately 19,100 projects that receive project-based subsidies under HUD's Section 8 housing assistance program. Under this program, tenants generally pay 30 percent of their income for rent, and the federal government subsidizes the balance. In addition, FHA provides insurance on mortgages for multifamily rental properties. FHA insures $43 billion worth of mortgage loans supporting about 14,700 properties. About $32 billion of this insurance supports loans on multifamily apartment properties. The other $11 billion insures loans supporting about 1,400 projects such as nursing homes, hospitals, student housing, cooperatives, and condominiums.

According to HUD's data, about 9,000 multifamily rental properties are FHA-insured and also receive project-based assistance. About 900,000 units in these properties receive project-based assistance. Beginning in 1996 and continuing for years, large numbers of long-term contracts for Section 8 project-based assistance will expire. Under existing policies, these assistance contracts would generally be renewed when they expire.

I would now like to discuss the key problems affecting HUD's multifamily portfolio.

PROBLEMS AFFECTING THE MULTIFAMILY HOUSING PORTFOLIO

As we noted in our March 14, 1995, testimony before this Subcommittee,[1] both HUD and the Congress have a particularly vexing set of problems to deal with in the area of assisted multifamily housing. From the mid-1960s until 1982, FHA operated a dozen different combinations of mortgage insurance, direct loan, and subsidy programs. As HUD itself has acknowledged, many of these programs were flawed in their design and/or operation, resulting in a number of problems including the following.

Many properties receive more project-based Section 8 assistance than what is necessary to provide the households living in them decent affordable housing because HUD is subsidizing rents that are above market rents. In particular, this problem occurs under programs (the Section 8 New Construction and Substantial Rehabilitation programs) in which the Department paid for the initial costs of development by establishing rents above the market

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[1]Housing and Urban Development: Reform and Reinvention Issues (GAO/T-RCED-95-129, Mar. 14, 1995).

and continued to raise the rents regularly. This problem has become more critical as the Congress faces decisions on how to address rising housing subsidy costs in its efforts to reduce the federal budget deficit. On May 1, 1995, HUD estimated that its costs to renew existing contracts for Section 8 rent subsidies will grow from about $5 billion in fiscal year 1996 to about $14 billion in fiscal year 1998.

In properties covered under other housing programs that operate under different terms, HUD has often held the rents below market rates because it did not want tenants' rental payments to increase. HUD believes that insufficient rental income in these programs has resulted in deterioration in the physical condition of many of the properties.

Other problems stem from the Department's dual role as assistance provider and insurer. This dual role has contributed to inadequate enforcement of HUD's standards for the condition of properties and decisions by HUD to increase subsidies in order to avoid claims stemming from loan defaults.

The design and operational problems affecting HUD's multifamily housing portfolio have been compounded as a result of weaknesses in HUD's ability and efforts to manage this portfolio effectively. As noted in our recent report on default prevention,[2] inadequate management has resulted in very poor living conditions for families with low incomes in a number of insured multifamily properties and contributed to a large number of past and anticipated defaults on FHA-insured loans. Long-standing deficiencies in staffing, data systems, and management controls have impeded HUD's management of its portfolio. For example, HUD does not have the right mix of staff with the proper skills to service multifamily loans and also lacks the data systems it needs to adequately support its loan servicing functions.

In addition, inadequate management of the multifamily portfolio has prevented HUD from consistently identifying and resolving problems that could lead to insurance claims, excessive rental subsidies, and/or substandard living conditions, and the Department's field offices have not adequately followed up with property owners and management agents to ensure that identified problems have been corrected. Furthermore, as discussed in our 1994 testimony, HUD has a wide range of enforcement tools to ensure that owners maintain their properties--such as the option to limit

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[2]<u>HUD Management: FHA's Multifamily Loan Loss Reserves and Default Prevention Efforts</u> (GAO/RCED/AIMD-95-100, June 5, 1995).

an owner's future participation in HUD's programs--but it has used these tools sparingly and inconsistently.[3]

HUD is undertaking a number of initiatives to strengthen its ability to manage its multifamily housing portfolio. However, many of these initiatives are in the early stages, and it is still too early to determine how effective they will be. In addition, proposed organizational changes and staffing cuts at HUD could, at least in the short run, place additional strains on management of the portfolio and on the implementation of HUD's initiatives to prevent loan defaults. In December 1994, HUD issued its "Reinvention Blueprint" proposing broad departmental changes, including restructuring FHA, in an effort to operate more efficiently and effectively. HUD's fiscal year 1996 budget proposal to begin implementing the blueprint would streamline HUD's headquarters and field office operations, reducing staff from the current level of 12,000 to about 7,500 over the next 5 years.

RATIONALE FOR AND CONCEPTUAL FRAMEWORK OF MARKING TO MARKET

Through its mark-to-market proposal, HUD intends to restructure segments of its multifamily housing portfolio to address operational and structural flaws. In particular, the proposal is aimed at addressing what HUD believes to be the most critical problem affecting the portfolio--the interdependence of subsidies and insurance claims.

HUD's mark-to-market proposal is intended to address these flaws by eliminating or phasing out project-based assistance for the vast majority of assisted properties that are also insured by FHA as the Section 8 contracts on these properties expire. HUD does not propose to abrogate existing Section 8 contracts. Residents living in units that receive project-based assistance would receive tenant-based assistance when the project-based assistance was terminated.

Mortgages on many properties are likely to end in default if project-based assistance is discontinued. Accordingly, the proposal would establish mechanisms for adjusting the projects' mortgages if such action is needed for the properties to be able to compete in the commercial rental market without project-based assistance. According to HUD, this adjustment, which would bring properties' income and expenses into line, would eventually allow the properties to be operated without project-based assistance. As we will discuss later, this adjustment could be done in various ways. However, any approach is likely to result in billions of

[3]Federally Assisted Housing: Condition of Some Properties Receiving Section 8 Project-Based Assistance Is Below Housing Quality Standards (GAO/T-RCED-94-273, July 26, 1994).

dollars in costs stemming from claims against FHA's insurance fund.

The effects of marking to market would vary, depending on whether a property is currently overvalued or undervalued. For a property whose rents exceed market value, marking to market would lower the property's mortgage debt, thereby allowing the property to operate at the lower market rents. This change should also lead to reductions in subsidy costs. For a property whose rents are below market value, marking to market would allow the property's rents to increase--potentially providing more money to restore and maintain the property. HUD recognizes that some properties will not be able to provide sufficient income to cover operating expenses even if the mortgage payments for the properties are reduced to zero. In those cases, HUD proposes using alternative resolution methods, including demolition of the property and subsequent sale of the land to a third party, such as a nonprofit organization or local government entity.

As we will discuss later, many of the strategies HUD will use to implement its mark-to-market proposal are still being developed.

PROPERTIES AFFECTED BY MARKING TO MARKET

HUD's mark-to-market proposal targets properties that both receive project-based section 8 assistance and have mortgages insured by FHA. Over 90 percent of these properties can be categorized as either "older assisted" or "newer assisted."[4] The older assisted properties are insured under either the section 221(d)(3) below market interest rate program or the section 236 program that also receive Section 8 loan management set-aside assistance. HUD's data indicate that there are about 4,200 of these properties, with over 400,000 units. The newer assisted properties are insured under any mortgage insurance program that also receives rental assistance under the Section 8 New Construction or Substantial Rehabilitation programs. HUD's data indicate that there are 4,100 of these properties, with about 400,000 units.

Both the older and newer assisted properties primarily serve very-low income households. About 77 percent of the households in the older assisted properties and 90 percent of households in the newer assisted properties have incomes that are less than 50 percent of the local area median. Both the older and newer

[4]HUD classifies the remaining properties as "other assisted." These include properties that are insured under either the section 221 market rate, section 220, or section 207 programs which also receive Section 8 assistance. Properties that were sold with insurance under HUD's property disposition program are also included.

assisted properties also have a large number of elderly households. About 30 percent of the households in the older properties and 47 percent of those in the newer properties are headed by elderly individuals.[5]

The rents in most of the older assisted properties are believed to be less than the market rent charged for comparable unassisted units, while the rents in most of the newer assisted projects exceed the market rent. HUD's data indicate that about 67 percent of the older properties have assisted rents that are lower than the market rents they could command.[6] On the other hand, almost 80 percent of the newer assisted properties have rents that exceed the market rent. (See app. I.) The same relationship holds when comparing assisted rents to the fair market rents that HUD uses as a basis for computing rent subsidies.[7] About 96 percent of the older assisted properties have rents that are less than the fair market rents while only 4 percent exceed such rents. About 75 percent of the newer assisted properties have rents in excess of the fair market rents.

The financial and physical condition of both the older and newer assisted properties varies. HUD's analysis for the fiscal year 1994 multifamily loan loss reserve evaluated the risk of default for a sample of multifamily projects on the basis of a set of financial, physical, and management data. Properties were then categorized as either excellent, good, standard, substandard, or doubtful. According to the analysis, only 14 percent of the older assisted properties were classified as excellent or good properties whose risk of default and risk of loss in the event of default were considered low. Another 38 percent were ranked as standard properties that do not currently pose a substantial degree of risk but have deficiencies that may pose an increased risk of loss in the future. The remaining 48 percent were either substandard properties whose risk of default and risk of loss were considered medium to high or doubtful properties that presented a high risk of loss. Of the newer assisted properties, 52 percent were considered excellent or good, 28 percent were standard, and the remaining 20 percent were substandard or doubtful.

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[5]Information based on study entitled Assessment of the HUD-Insured Multifamily Housing Stock, Current Status of HUD-Insured (or Held) Multifamily Rental Housing, Abt Associates, Inc., September 1993.

[6]Information based on HUD memorandum dated January 1995.

[7]HUD annually sets fair market rents for each metropolitan and nonmetropolitan area in each state. These rents represent the cost of modest rental units of a given size and are used to compute Section 8 rent subsidies.

COSTS OF MARKING TO MARKET

During the past few months, HUD has been developing short- and long-term cost estimates for its mark-to-market proposal. HUD's estimates compare the cost of its mark-to-market proposal with two baseline estimates that represent the status quo option of renewing Section 8 contracts on current terms and conditions as they expire and continuing to provide additional subsidies to reduce insurance claims. The principal differences between the "official" baseline status quo estimate and the "realistic" baseline are that (1) the latter assumes that claims against FHA will increase as the existing stock ages, whereas the official baseline estimate does not, and (2) the increases in subsidy costs are assumed to be higher under the realistic baseline.

HUD's most recent analysis (dated May 30, 1995) estimates that the mark-to-market proposal would cost $600 million more than either of the two baseline estimates for fiscal year 1996. For a 5-year period, HUD estimates that marking to market would cost $3.7 billion more than the official baseline and $2.7 billion more than the realistic baseline. Finally, HUD estimates the 25-year costs of marking to market computed on a net present value basis would be slightly higher than the official baseline but about $8.6 billion less than the realistic baseline. (See app. II.)

While HUD deserves credit for its efforts in developing these cost estimates, the limitations of the estimates need to be recognized. The estimates are still preliminary and continue to be revised to reflect, for example, policy and implementation decisions that are still being developed. In addition, and equally as important, some essential information is not available, and "best guess" assumptions must be used. For example, HUD does not have complete data on comparable market rents, the physical and financial condition of the properties currently receiving rental assistance, the structure of project ownership, and other relevant factors that will affect costs. Furthermore, HUD has developed assumptions about relevant unknowns, such as (1) the amount of claims that will result from mortgage restructuring and (2) the number of tenants who will move when portable tenant-based certificates become available--a variable that will affect future subsidy costs. Predicting the reactions of numerous owners, lenders, and tenants to the proposal is difficult at best and subject to significant error.

MARK TO MARKET ISSUES AND OBSERVATIONS

In evaluating HUD's mark-to-market proposal, the Congress faces a number of significant, and in many cases, highly complex issues. How these issues are resolved will, to a large degree, determine to what extent the mark-to-market proposal will correct the problems that now hamper the performance of HUD's multifamily housing portfolio and the amount of any net savings to the government that will result. The key issues include the following.

How Multifamily Mortgages Should Be Restructured

HUD's legislative proposal would authorize the Department to use a variety of tools to restructure mortgages, including full and partial payments of claims, sales of mortgages using such procedures as the Secretary of HUD may determine, and agreements with third parties to facilitate mortgage restructuring. Depending on the particular approach or combination of approaches actually used, the effects could be vastly different for the current property owners and tenants, new investors, and the degree to which the process results in long-term net cost increases or savings to the government.

How Quickly Mark to Market Needs to Be Implemented

Appreciable reductions in Section 8 costs will not be realized until projects with New Construction/Substantial Rehabilitation Section 8 contracts are marked to market. Contracts for these projects expire primarily from 1998 through 2004. (See app. III.) Accordingly, some parties, including the National Housing Conference, believe that there is no need for precipitous action on HUD's proposal. However, HUD believes it important to begin implementing the mark-to-market approach expeditiously to prevent disinvestment by multifamily project owners in light of the uncertainty about the continuation of project-based assistance. Such disinvestment could result in property deterioration, loss of value, and higher costs.

To What Extent the Government Should Finance Project Rehabilitation

While HUD plans to rely primarily on the private sector to pay for rehabilitation needed to make properties competitive in the marketplace, it believes that relying exclusively on the private sector may not always be the most desirable option, particularly in tight real estate markets. HUD is thus seeking authority to provide advances or grants for rehabilitation when necessary. If this assistance is used to substitute for private investment or to rehabilitate properties that should be demolished, the costs of HUD's mark-to-market approach would increase.

Whether Loans Should Be Sold With or Without FHA Insurance

HUD intends that mortgages resolved through the mark-to-market process would no longer carry any FHA insurance, assuming that legislative authorization is granted. As HUD points out, doing so would result in valuing mortgages at the underlying real estate value of the asset. On the other hand, selling loans with FHA insurance adds value to the loans and thus could decrease costs to the FHA insurance fund, at least in the short run. However, it would also expose the fund to the risk of future losses.

What Level of Protection and Assistance Should Be Provided to Tenants After Project-Based Subsidies Are Discontinued

A variety of concerns have been expressed over HUD's proposal to convert from project-based assistance to tenant-based assistance. For example, while HUD has noted that there is concern that this change will lead to large-scale displacement--as many as 200,000 families--in the first 10 years, HUD believes that these estimates are exaggerated and ignore the fact that elderly and disabled households will be given special protection. According to HUD, while displacements will occur, only about 95,000 households will be affected over a 25-year time period. A clear understanding is needed of the extent to which marking to market will result in the displacement of tenants and of the actions needed to address this problem.

How to Improve the Usefulness of Tenant-based Assistance

Under the mark-to-market process, a key change for tenants would be greater flexibility and choice in deciding where they want to live, stemming from the substitution of portable, tenant-based rent subsidies for subsidies tied to a single property. While holders of HUD's existing tenant-based Section 8 subsidies have for the most part been successful in obtaining housing, this is not always the case. Certain requirements of the current program, such as the "take one, take all" rule, have made some property owners reluctant to participate. At issue is what changes are needed in tenant-based assistance to encourage greater acceptance of the increased number of tenant-based certificates that will result from marking to market.

To What Extent Properties With Assisted Rents Below Local Market Rents Should Be Included in Mark to Market

HUD believes that marking to market those properties whose rents are currently below market levels can help improve the properties' physical and financial condition, reduce the likelihood that a default will occur, and give the tenants now living in units with project-based assistance the option to move elsewhere. However, including such properties in the mark-to-market approach is likely to increase housing assistance costs. For example, HUD's estimate of mark-to-market costs indicates that excluding the older assisted properties from this approach would cost $4 billion less over 25 years (on a net present value basis) than including them.

Observations

HUD's multifamily portfolio is plagued by a number of serious problems. While HUD has taken and is taking actions administratively to address these problems, it is far from clear how successful these actions will be--particularly given the capacity limitations that currently exist at HUD and are likely to continue into the future. Accordingly, we agree that new approaches are needed to reduce the excessive subsidy costs that HUD currently pays at many properties and to end the payment of subsidies to properties that do not provide safe, decent, and sanitary housing to low-income households.

The mark-to-market proposal is a significant departure from HUD's past efforts to deal with the problems affecting its multifamily portfolio. HUD's proposal involves complex issues and has potentially far reaching effects. It is important that these issues be resolved as quickly as possible since delays are likely to lead to project disinvestment, financial uncertainty, and, ultimately, higher costs to the Government.

We look forward to working with the Subcommittee as it assesses this important matter.

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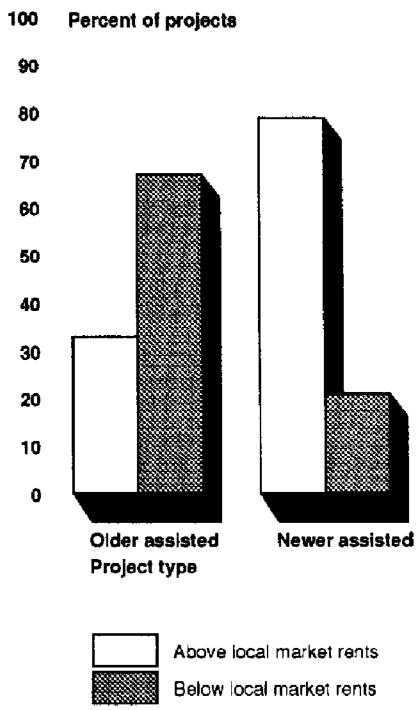
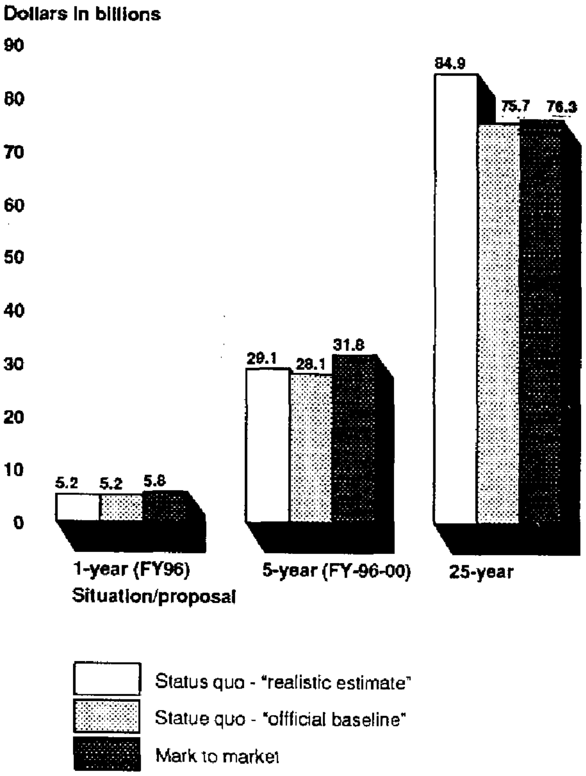
Mr. Chairman, this concludes our prepared remarks. We will be pleased to respond to any questions that you and other members of the Subcommittee might have.

PERCENT OF FHA-INSURED PROJECTS ABOVE AND BELOW LOCAL MARKET RENTS

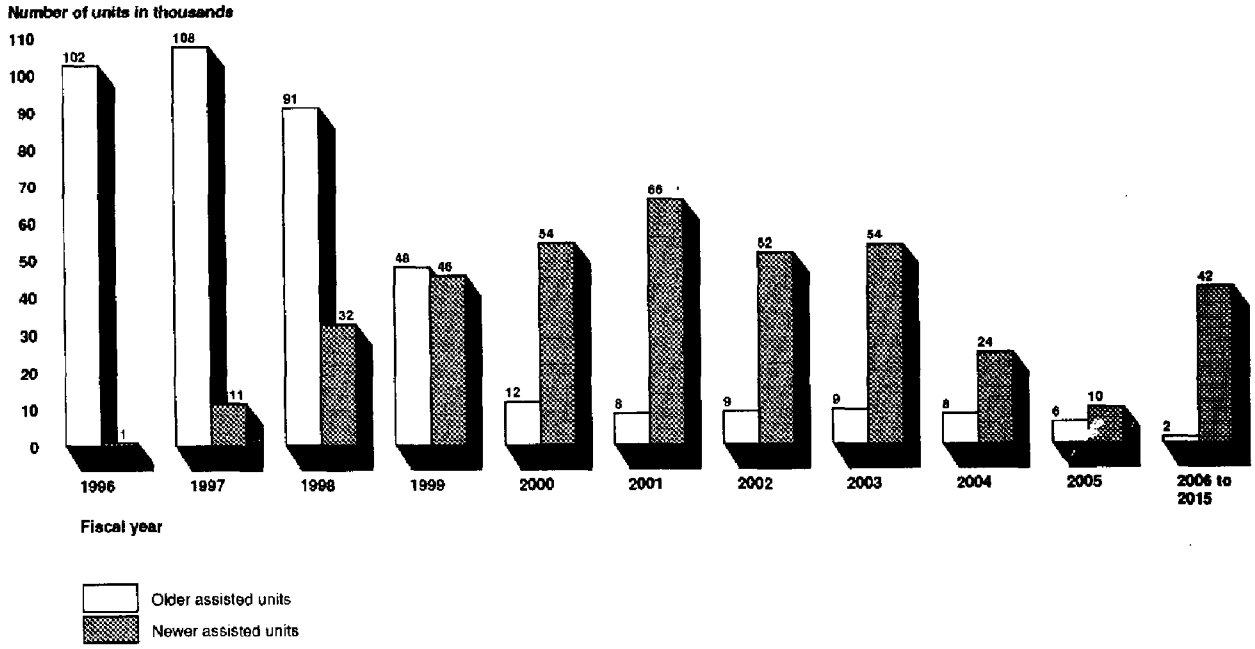


COMPARISON OF HUD'S COST ESTIMATES FOR THE MARK-TO-MARKET PROPOSAL WITH THE COSTS OF MAINTAINING SECTION 8 ASSISTANCE UNDER THE CURRENT PROGRAM STRUCTURE



Note: The 25-year costs are at present value.

UNITS WITH EXPIRING SECTION 8 CONTRACTS IN FHA-INSURED OLDER ASSISTED AND NEWER ASSISTED HOUSING PROJECTS



Note: Figure excludes 99,159 "other subsidized" units whose Section 8 contracts will expire between 1996 and 2008.

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