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MULTIFAMILY HOUSING

HUD's Proposals for Reengineering Its Insured Section 8 Portfolio

Statement for the Record by
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Mr. Chairman and Members of the Subcommittee:

We are pleased to submit this statement for the record in conjunction with the Subcommittee's June 27, 1996, hearing on proposals to reengineer about 8,600 properties from the Department of Housing and Urban Development's (HUD) multifamily rental housing portfolio. These 8,600 properties, which we refer to as the insured Section 8 portfolio, are properties that receive mortgage insurance from HUD through its Federal Housing Administration (FHA) and that receive Section 8 rental subsidies that are tied directly to the properties (Section 8 project-based assistance). During the past few years, this Subcommittee, HUD, GAO, and others have given increased attention to the problems affecting this segment of HUD's portfolio and to identifying possible strategies for resolving the problems while protecting the interests of all affected parties—property owners, residents, mortgage lenders, HUD, state and local housing agencies, and, of course, the federal taxpayer, who will ultimately benefit from the savings or bear the extra costs that result from the strategy that is adopted.

In May 1995, HUD proposed a resolution process it called "mark-to-market." In early 1996, HUD modified that process in response to stakeholders' concerns and renamed it "portfolio reengineering." This statement provides the preliminary results of our work on an assignment relating to HUD's proposals. In addition to providing background information on the insured Section 8 portfolio, this statement discusses (1) the problems currently affecting the portfolio, (2) HUD's plans for addressing these problems, (3) a HUD-contracted study by Ernst & Young LLP that estimates how the properties are likely to be affected by HUD's reengineering proposal, and (4) our preliminary assessment of Ernst & Young's study. We are also providing observations on HUD's portfolio reengineering initiative.

In summary, we found the following:

- The basic problems affecting the insured Section 8 portfolio are high subsidy costs, high exposure to insurance loss, and the poor condition of many properties. These problems stem from one or more of several basic causes. These include (1) program design flaws that have contributed to high subsidies and put virtually all the insurance risk on HUD; (2) HUD's dual role as mortgage insurer and rental subsidy provider, which has resulted in the federal government's averting claims against the FHA insurance fund by supporting a subsidy and regulatory structure that has masked the true market value of the properties; and (3) weaknesses in HUD's oversight and management of the insured portfolio, which have allowed physical and financial problems at a number of HUD-insured multifamily properties to go undetected or uncorrected.

- In 1995, HUD proposed to address these problems through a process it called "mark-to-market." This process would allow property owners to set rents at market levels, while HUD would reduce mortgage debt if necessary to permit a positive cash flow, terminate FHA's mortgage insurance, and replace project-based Section 8 subsidies with portable tenant-based subsidies. Although HUD expected the proposal to reduce the costs of Section 8 subsidies, lowering mortgage debt would result in claims against FHA's insurance fund. Many questions and concerns were raised about the proposal, including (1) whether data on the physical and financial condition of properties in the portfolio were reliable, (2) how the process would affect the properties and existing residents, and (3) whether the result would be a net saving or cost to the government. Without this information it was difficult to predict the overall effects of HUD's mark-to-market proposal on the properties, their owners, the residents, and the federal government. In response to the concerns, in early 1996 HUD made several changes to the proposal but left most of its basic thrust intact.
- During 1995, HUD also contracted with Ernst & Young LLP to obtain up-to-date information on market rents and the physical condition of the properties in the insured Section 8 portfolio and to develop a financial model to show how HUD's proposal would affect the properties. Ernst & Young's May 1996 report on the Department's proposal indicates that the vast majority of the insured Section 8 properties—between 77 and 83 percent—would need to have their debt reduced in order to continue operations. The study also estimates that between 22 and 29 percent of the properties in the portfolio would have difficulty sustaining operations even if their mortgages were totally forgiven. These projections are based on current data on market rents and the physical condition of the properties obtained by Ernst & Young. Furthermore, it is important to note that the study's results reflect the provisions contained in HUD's mark-to-market proposal prior to the changes that HUD made to the proposal in early 1996. The study also confirms earlier data that, for most of the properties subject to portfolio reengineering, the assisted rents are higher than the estimated market rents. In addition, the properties in the portfolio were found to have significant amounts of immediate deferred maintenance and short-term and long-term capital needs.
- Our preliminary analysis of Ernst & Young's financial model indicates that it provides a reasonable framework for studying the outcomes of portfolio reengineering, such as how many properties will need to have their debt

reduced. In addition, we did not identify any substantive problems with Ernst & Young's sampling and statistical methodology. We are still assessing how assumptions used in the model affect its estimates of the effects of portfolio reengineering. In addition, we are examining subsidy and claims cost data that were developed by Ernst & Young as part of its study but not included in its May 1996 report. Our preliminary analysis of these cost data indicates that the claims costs will be substantial—Ernst & Young's data indicate that the average debt writedown for properties whose mortgages need restructuring is approximately 61 to 67 percent of the insured loans' unpaid principal balances at the time of restructuring.

- In our view, HUD's portfolio reengineering initiative recognizes a reality that has existed for some time—namely, that the value of many of the properties in the insured Section 8 portfolio is far less than the mortgages on the properties suggest. Until now, this reality has not been recognized and we have continued to subsidize the rents at many properties above the level the properties could command in the commercial real estate market. While HUD deserves credit for offering an approach that would address the major problems that affect the portfolio and potentially lead to long-term savings in Section 8 subsidy costs, the benefits achieved by the proposal may come at a high cost. Accordingly, it is important for the Congress to carefully examine HUD's proposal as well as any other proposals for reengineering HUD's insured Section 8 portfolio, taking into account the differences in the properties that make up the portfolio and the different ways that these properties will be affected by reengineering.

Background on the Portfolio and GAO's 10 Case Study Properties

HUD, through FHA, provides insurance that protects private lenders from financial losses stemming from borrowers' defaults on mortgage loans for both single-family homes and multifamily rental housing properties for low- and moderate-income households. When a default occurs on an insured loan, a lender may "assign" the mortgage to HUD and receive payment from FHA for an insurance claim. According to the latest data available from HUD, FHA insures mortgage loans for about 15,800 multifamily properties. These properties contain just under 2 million units and have a combined unpaid mortgage principal balance of $46.9 billion.[1] These properties include multifamily apartments and other specialized properties, such as nursing homes, hospitals, student housing, and condominiums.

[1]These data do not include "HUD-held" mortgages, which are those for which HUD has paid an insurance claim and is now, in effect, the lender. According to its data, HUD holds mortgages on 1,609 properties that have a combined unpaid principal balance of $5.4 billion.

In addition to mortgage insurance, many FHA-insured multifamily properties receive some form of direct assistance or subsidy from HUD, such as below-market interest rates or Section 8 project-based assistance. HUD's Section 8 program provides rental subsidies for low-income families. These subsidies are linked either to multifamily apartment units (project-based) or to individuals (tenant-based). According to HUD's latest available data, about 1.4 million units at about 20,400 multifamily properties receive Section 8 project-based subsidies. Under the Section 8 program, residents in subsidized units generally pay 30 percent of their income for rent and HUD pays the balance.

According to HUD, its restructuring proposals apply to 8,636 properties that both have mortgages insured by FHA and receive project-based Section 8 rental subsidies for some or all of their units. Data provided by HUD in April 1996 show that, together, these properties have unpaid principal balances totaling $17.8 billion and contain about 859,000 units, of which about 689,000 receive project-based Section 8 subsidies.[2] According to HUD's data, about 45 percent of the insured Section 8 portfolio (3,859 properties, 303,219 assisted units, and $4.8 billion in unpaid loan balance) consist of what are called the "older assisted" properties. These are properties that were constructed beginning in the late 1960s under a variety of mortgage subsidy programs, to which project-based Section 8 assistance (Loan Management Set Aside) was added later, beginning in the 1970s, to replace other subsidies and to help troubled properties sustain operations. About 55 percent of the insured Section 8 portfolio (4,777 properties, 385,931 assisted units, and $13.0 billion in unpaid loan balance) consists of what are called the "newer assisted" properties. These properties generally were built after 1974 under HUD's Section 8 New Construction and Substantial Rehabilitation programs and received project-based Section 8 subsidies based on formulas with automatic annual adjustments, which tended to be relatively generous to encourage the production of affordable housing.

There is great diversity among the properties in HUD's insured Section 8 portfolio, as illustrated by the 10 properties that we studied in greater depth as part of our current assignment. These properties differ in a number of important respects, such as the amount of their remaining unpaid mortgage debt; the types and amounts of assistance they receive from HUD; and their financial health, physical condition, rents, types of

[2]For various reasons, HUD chose to exclude from its restructuring proposals properties with project-based Section 8 assistance that was provided under its "moderate rehabilitation" program. HUD estimates that there are about 167 insured moderate rehabilitation properties containing about 16,800 units.

residents served, and surrounding neighborhoods and rental housing markets. These factors can influence the effect that HUD's or other reengineering proposals would have on the properties.

There is wide variation in the size of the insured mortgages at these properties. The unpaid mortgage balances at our 10 properties (as of Dec. 31, 1995) ranged from about $731,000 to almost $75 million. There is also wide variation in the types and amounts of assistance HUD provides to the properties. For example, HUD provides project-based Section 8 rental subsidies for all 60 apartment units at the smallest of our 10 properties but for only 119 of the 594 units at the largest property. In addition, the rents that HUD subsidizes vary greatly. The rents for a one-bedroom apartment, for instance, ranged from $332 to $1,231. HUD also subsidizes the interest rate at six of the properties, reducing the rate actually paid by the properties to between 1 and 2 percent. The other four properties pay mortgage interest rates ranging from 7.5 percent to 11.9 percent. Furthermore, 3 of our 10 properties also have received low-interest loans from HUD for repairs and maintenance, and 2 of these 3 have received grants from HUD to combat drug-related crime. Finally, the financial and physical conditions of our 10 case study properties also varied substantially.

The majority of the residents in our 10 case study properties have low incomes. According to the properties' records, between 60 percent and 96 percent of the Section 8 units at each property are occupied by households earning less than $10,000 per year. However, the properties tend to serve different types of households. At six of the properties, all or almost all of the Section 8 units are occupied by elderly or disabled persons, while at the other four properties, family and single adult households constitute a much larger percentage (in three cases, a majority) of the assisted households.

Our 10 case study properties are located in various types of communities: 6 in urban communities, 3 in suburban communities, and 1 in a rural community. The properties' neighborhoods also vary in terms of their economic and social conditions, ranging from areas with declining physical conditions, high crime rates, high unemployment, abandoned buildings, and/or frequent drug activity, to areas with economic growth, lower crime rates, and high income levels. Some properties are in neighborhoods dominated by multifamily, government-subsidized housing, while others are in neighborhoods dominated by unsubsidized housing, and in some cases single-family residences. The rental housing markets in the neighborhoods also vary, with occupancy rates ranging from about 88 percent to 100 percent.[3]

Problems Affecting the Portfolio

The insured Section 8 portfolio suffers from three basic problems—high subsidy costs, high exposure to insurance loss, and in the case of some properties, poor physical condition.

A substantial number of the properties in the insured Section 8 portfolio now receive subsidized rents above market levels, many substantially above the rents charged for comparable unsubsidized units. This problem is most prevalent in (but not confined to) the "newer assisted" segment of the portfolio, where it stems from the design of the Section 8 New Construction and Substantial Rehabilitation programs. The government paid for the initial development or rehabilitation of these properties under these programs by initially establishing rents above market levels and then raising them regularly through the application of set formulas that tended to be generous to encourage the production of new affordable housing.

The overall high cost of Section 8 subsidies is reflected in the cost of renewing the existing project-based contracts for the properties in the insured Section 8 portfolio as they expire.[4] For example, HUD is requesting $863 million in budget authority in fiscal year 1997 to renew expiring contracts covering almost 293,000 units in the insured Section 8 portfolio. As long-term Section 8 contracts expire and 1-year contract renewals continue to roll over annually, HUD's estimated annual renewal costs will increase steadily in each of the following 9 fiscal years.

A second key problem affecting the portfolio is the high risk of insurance loss. Under FHA's insurance program, HUD bears virtually all the risk in the event of loan defaults. A third, closely related problem is the poor physical condition of many properties in the portfolio. A 1993 study of multifamily rental properties with FHA-insured or HUD-held mortgages found that almost one-fourth of the properties were "distressed." Properties were considered to be distressed if they failed to provide sound housing and

[3]We are analyzing how the case study properties would be affected by portfolio reengineering.

[4]The project-based Section 8 assistance for properties in the insured Section 8 portfolio is covered by contracts, many of which are long term. Under these contracts, property owners agreed to house lower-income tenants for specified periods in exchange for guaranteed rental subsidies for specified units. In the next few years, many of these contracts will expire. According to the available data from HUD, contracts covering about 69 percent of the project-based Section 8 units in the insured Section 8 portfolio will expire by the end of the year 2000 and contracts covering about 98 percent of the units will expire by the end of the year 2006.

lacked the resources to correct deficiencies or if they were likely to fail financially.

As we noted in testimony last year, the problems affecting HUD's insured Section 8 portfolio stem from several causes.[5] These include (1) program design flaws that have contributed to high subsidies and put virtually all the insurance risk on HUD; (2) HUD's dual role as mortgage insurer and rental subsidy provider, which has resulted in the federal government averting claims against the FHA insurance fund by supporting a subsidy and regulatory structure that has masked the true market value of the properties; and (3) weaknesses in HUD's oversight and management of the insured portfolio, which have allowed physical and financial problems at a number of HUD-insured multifamily properties to go undetected or uncorrected.

HUD's Plans for Addressing Problems With the Portfolio

The basic concept behind HUD's May 1995 mark-to-market proposal was to address the three key problems and their causes by decoupling HUD's mortgage insurance and project-based rental subsidies and subjecting the properties to the forces and disciplines of the commercial market. HUD proposed to do this by (1) eliminating the project-based Section 8 subsidies as existing contracts expired (or sooner if owners agreed), (2) allowing owners to rent apartments for whatever amount the marketplace would bear, (3) facilitating the refinancing of the existing FHA-insured mortgage with a smaller mortgage if needed for the property to operate at the new rents, (4) terminating the FHA insurance on the mortgage, and (5) providing the residents of assisted units with portable Section 8 rental subsidies that they could use to either stay in their current apartment or move to another one if they wanted to or if they no longer could afford to stay in their current apartment.

Recognizing that many properties could not cover their expenses and might eventually default on their mortgages if forced to compete in the commercial market without their project-based Section 8 subsidies, the mark-to-market proposal set forth several alternatives for restructuring the FHA-insured mortgages in order to bring income and expenses in line. These alternatives included selling mortgages, engaging third parties to work out restructuring arrangements, and paying full or partial FHA insurance claims to reduce mortgage debt and monthly payments.

[5] Multifamily Housing: HUD's Mark-to-Market Proposal (GAO/T-RCED-95-230, June 15, 1995).

The proposed mark-to-market process would likely affect properties differently, depending on whether their existing rents were higher or lower than market rents. If existing rents exceeded market rents, the process would lower the mortgage debt, thereby allowing a property to operate and compete effectively at lower market rents. If existing rents were below market, the process would allow a property to increase rents, potentially providing more money to improve and maintain the property. HUD recognized, however, that some properties would not be able generate sufficient income to cover expenses even if their mortgage payments were reduced to zero. In those cases, HUD proposed using alternative strategies, including demolishing the property and subsequently selling the land to a third party, such as a nonprofit organization or government entity.

Although both the Senate and House held hearings in 1995 on the mark-to-market proposal, no consensus was reached on whether it or some other approach should be adopted. Part of the reason for this was the lack of reliable data on the properties and their surrounding rental markets. Various potential stakeholders raised important unanswered questions and concerns about the mark-to-market proposal. They sought information on the physical and financial conditions of the properties in the insured Section 8 portfolio, the effects of the proposed strategy on different types of properties, and the long-term financial impact of the proposal on the government. Without this information, it was difficult to predict the overall effects of HUD's mark-to-market proposal on the properties, their owners, the residents, and the federal government.

While leaving much of its original mark-to-market proposal intact, HUD in early 1996 made several changes to the proposal in response to stakeholders' concerns. HUD also renamed the proposal "portfolio reengineering." These changes included (1) giving priority attention for at least the first 2 years to properties with subsidized rents above market; (2) allowing state and local governments to decide whether to continue Section 8 project-based rental subsidies at individual properties after their mortgages are restructured or switch to tenant-based assistance; and (3) allowing owners to apply for FHA insurance on the newly restructured mortgage loans. In addition, HUD stated a willingness to discuss with the Congress mechanisms to take account of tax consequences related to debt forgiveness for property owners who enter into restructuring agreements. More recently, HUD has also suggested that action on properties that would not be able to generate sufficient income to cover operating expenses after reengineering should be deferred until strategies are developed that address community and resident needs relating to the properties.

Objectives and Results of Ernst & Young's Study

In May 1995, when HUD proposed the mark-to-market initiative, the Department did not have current or complete information on the insured Section 8 portfolio upon which to base assumptions and estimates about the costs and impact of the proposal. For example, HUD lacked reliable, up-to-date information on the market rents the properties could be expected to command and the properties' physical conditions—two variables that strongly influence how properties will be affected by the mark-to-market proposal. To obtain data to better assess the likely outcomes and costs of the mark-to-market proposal, HUD contracted with Ernst & Young LLP[6] in 1995 for a study on HUD-insured properties with Section 8 assistance to (1) determine the market rents and physical condition of the properties and (2) develop a financial model to show how the proposal would affect the properties and to estimate the costs of subsidies and claims associated with the mark-to-market proposal.

The study was conducted on a sample of 558 of 8,363 properties and extrapolated to the total population of 8,563 properties identified by HUD at that time as representing the population subject to its mark-to-market proposal.[7] The sample was designed to be projectible to the population with a relative sampling error of no more than plus or minus 10 percent at the 90-percent confidence level. A briefing report summarizing the study's findings was released by HUD and Ernst & Young on May 2, 1996. It provides current information on how assisted rents at the properties compare with market rents, the physical condition of the properties, and how the properties are expected to be affected by HUD's proposal as the proposal existed while the study was under way. As such, it is important to note that the study's results do not reflect the changes that HUD made to its proposal in early 1996.

Study Confirms Excess Subsidy Costs and Significant Physical Needs at Properties

Ernst & Young estimates that the majority of the properties have assisted rents exceeding market rents and that the properties have significant amounts of immediate deferred maintenance and short-term and long-term capital needs.[8] Specifically, Ernst & Young's study estimates that a

[6]The study was conducted by the E&Y Kenneth Leventhal Real Estate Group.

[7]Ernst & Young reported that the sample was drawn from a population of 8,363 properties rather than the HUD-identified population of 8,563 properties because of technical and cost considerations. As noted earlier, HUD now believes that 8,636 properties would be subject to portfolio reengineering.

[8]The study defines three categories of capital items: (1) immediate deferred maintenance, the estimated costs to bring all property operating systems up to market conditions and lender underwriting standards; (2) short-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in 5 years or less; and (3) long-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in more than 5 years.

majority of the properties—between 60 and 66 percent—have rents above market and between 34 and 40 percent are estimated to have below-market rents. Ernst & Young's data also indicate a widespread need for capital—between $9.2 billion and $10.2 billion—to address current deferred maintenance needs and the short- and long-term requirements to maintain the properties. The study estimates that the properties have between $1.3 billion and $1.6 billion in replacement and cash reserves that could be used to address these capital needs, resulting in total net capital needs of between $7.7 billion and $8.7 billion. The average per-unit cost of the total capital requirements, less the reserves, is estimated to be between $9,116 and $10,366.

Study Indicates a Significant Level of Debt Restructuring Would Be Needed

Ernst & Young's analysis also indicates that about 80 percent of the properties would not be able to continue operations unless their debt was restructured. Furthermore, for approximately 22 to 29 percent of the portfolio, writing the existing debt to zero would not sufficiently reduce costs for the properties to address their immediate deferred maintenance and short-term capital needs. The study estimates that between 11 and 15 percent of the portfolio would not even be able to cover operating expenses.

The study was designed to use the information on market rents and properties' physical condition gathered by Ernst & Young, as well as financial and Section 8 assistance data from HUD's data systems, in a financial model designed to predict the proposal's effects on the portfolio as a whole. Specifically, the model estimates the properties' future cash flows over a 10-year period on the basis of the assumption that they would be reengineered (marked to market) when their current Section 8 contracts expire.[9]

The model classifies the loans into four categories—performing, restructure, full write-off, and nonperforming—that reflect how the properties would be affected by HUD's proposal. Placement in one of the four categories is based on the extent to which income from the reengineered properties would be able to cover operating costs, debt service payments, deferred maintenance costs, and short-term capital expenses. Table 1 shows the results of Ernst & Young's analysis of how properties would be affected by HUD's proposal.

[9]For properties with more than one Section 8 contract, the model assumes that the property would be reengineered when the contract with the earliest expiration date expires.

Table 1: Effects of Reengineering on HUD's Insured Section 8 Portfolio

Status of loan after reengineering	Percent of portfolio	Costs covered with reengineered cash flows
Performing	17 to 23	Existing debt, operating expenses, all capital needs
Restructure	50 to 58	Restructured debt, operating expenses, all capital needs
Full write-off	11 to 15	Operating expenses and some capital needs but no debt
Nonperforming	11 to 15	Some operating expenses but no debt or capital needs

Note: Capital needs represent immediate deferred maintenance and short-term (5 years or less) capital needs. In addition, the financial model categorizing the loans assumes annual deposits to replacement reserves.

GAO's Assessment of the Model and the Results

We are currently evaluating Ernst & Young's financial model and expect to issue our report late this summer. Our preliminary assessment is that the model provides a reasonable framework for studying the overall results of portfolio reengineering, such as the number of properties that will need to have their debt restructured, and to estimate the related costs of insurance claims and Section 8 subsidies. In addition, we did not identify any substantive problems with Ernst & Young's sampling and statistical methodology. However, our preliminary assessment of the study indicates that some aspects of Ernst & Young's financial model and its assumptions may not reflect the way in which insured Section 8 properties will actually be affected by portfolio reengineering. Also, some of the assumptions used in the model may not be apparent to readers of Ernst & Young's May 1996 briefing report.

For example, Ernst & Young's assumptions about the transition period that properties go through in the reengineering process may be overly optimistic. During the transition, a reengineered property changes from a property with rental subsidies linked to its units to an unsubsidized property competing in the marketplace for residents. The model estimates that the entire transition will be completed within a year after the first Section 8 contract expires. In addition, the model assumes that during this year, the property's rental income will move incrementally towards stabilization over 9 months. Lenders with whom we consulted on the reasonableness of the model's major assumptions generally believed that a longer transition period of 1 to 2 years is more likely. They also anticipated an unstable period with less income and more costs during the transition rather than the smooth transition assumed in the model. An Ernst & Young official told us that the 9-month period was designed to reflect an average transition period for reengineered properties. While he recognized that some properties would have longer transition periods than assumed in the model, he believed that the transition periods for other properties could be shorter than 9 months.

In addition, Ernst & Young's May 1996 report does not detail all of the assumptions used in the firm's financial model that are useful to understanding the study's results. In particular, the model assumes that the interest subsidies some properties currently receive will be discontinued after the first Section 8 contract expires, including those in the performing category whose debts do not require restructuring.

We are currently examining how the assumptions contained in Ernst & Young's study affect its estimates of the effects of portfolio reengineering. In addition, we are assessing how the use of alternative assumptions would affect the study's results.

We also observed that although Ernst & Young's study provided information on the cost to the government of the portfolio reengineering proposal, the May report did not provide these results.[10] We are currently examining Ernst & Young's data and will provide cost estimates derived from Ernst & Young's model covering changes in the Section 8 subsidy costs and FHA insurance claims. Our preliminary review of this information indicates that the costs of claims will be significant. On average, the data indicate that mortgage balances for properties needing mortgage restructuring—including those in the full write-off and nonperforming categories that would have their mortgages totally written off—would need to be reduced by between 61 and 67 percent. This reduction would result in claims against FHA's multifamily insurance funds.

Observations

HUD's portfolio reengineering initiative recognizes a reality that has existed for some time—namely, that the value of many of the properties in the insured Section 8 portfolio is far less than the mortgages on the properties suggest. Until now, this reality has not been recognized and we have continued to subsidize the rents at many properties above the level the properties could command in the commercial real estate market.

[10]According to HUD's Deputy Assistant Secretary for Operations, Office of Housing, while cost data were developed by Ernst & Young, HUD never intended that the data be included as a part of the report on the results of Ernst & Young's study.

In our view, HUD deserves credit for offering an approach that would address the major problems that have affected the portfolio. For example, the proposal, if implemented, should lead to long-term savings in the costs of Section 8 subsidies, although how soon and to what extent these savings are realized will depend on how, when, and which properties are reengineered. Furthermore, by subjecting properties to the discipline of the marketplace, the proposal should reduce the need for governmental oversight and regulation. To the extent that FHA-insured mortgages on the properties are terminated, the proposal would also relieve the government of the risk of future defaults on loans. Moreover, by making housing assistance subsidies tenant-based rather than project-based, the proposal potentially offers residents the opportunity to leave properties that fail to provide adequate housing.

Unfortunately, however, these benefits may come at a high cost. As Ernst & Young's data indicate, the vast majority of the properties will need mortgage writedowns to survive in a market-rate environment and the insurance claims associated with those writedowns will be substantial—on average, around 61 to 67 percent of the properties' mortgages. In addition, the proposal may cause the loss of affordable housing and may displace residents if, as the study suggests, up to almost 30 percent of the properties in the portfolio will have difficulty sustaining operations without financial support in addition to a full writedown of their current mortgages. Accordingly, it will be important for the Congress to carefully examine HUD's proposal as well as any other proposals to reengineer HUD's insured Section 8 portfolio, taking into account the differences in the properties that make up the portfolio and the different ways that these properties will be affected by reengineering.

As indicated earlier in our statement, we are continuing to review the results of Ernst & Young's study and other issues associated with portfolio reengineering, and we will look forward to sharing the results of our work with the Subcommittee as it is completed.

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