United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services, House of Representatives

July 26, 1996
10:00 a.m. EDT

MULTIFAMILY HOUSING

Issues Facing the Congress in Assessing HUD's Portfolio Reengineering Proposal

Statement by Judy A. England-Joseph, Director, Housing and Community Development Issues, Resources, Community, and Economic Development Division

GAO/T-RCED-96-231

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to testify before this Subcommittee as it examines 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 process called "mark-to-market" that was aimed at addressing these and other problems. In early 1996, HUD modified that process in response to stakeholders' concerns and renamed it "portfolio reengineering." This statement is based on previous work we have carried out on HUD's multifamily portfolio and also 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, (4) our preliminary assessment of Ernst & Young's study, and (5) issues facing the Congress in deciding how to respond to HUD's proposal. 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 those in the insurance program that put virtually all the 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 a 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 its 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 data also indicate 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 the assumptions used in the model affect its estimates of the effects of portfolio reengineering. In addition, we are examining data on subsidy and claims costs that were developed by Ernst & Young as part of its study, but not included in its May 1996 report. Our preliminary analysis of that 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.

- The Congress will face a number of other key issues in considering HUD's portfolio reengineering proposal. These include (1) whether rental assistance should be project-based or tenant-based, (2) what protection should be given households that could be displaced as a result of reengineering, (3) to what extent FHA insurance should be used for restructured loans, and (4) to what degree the federal government should finance rehabilitation costs. How these issues are resolved will, to a large degree, determine the extent to which the problems that have long plagued the portfolio are corrected and prevented from recurring and the extent to which the reengineering process results in savings to the government.

Background on the Portfolio

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.

In addition to mortgage insurance, many FHA-insured multifamily properties receive some form of direct assistance or subsidy from HUD,

[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.

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). 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 balances) 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 balances) 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 10 properties that we studied in greater depth as part of our current assignment (see app. I). 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 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.

[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.

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. It has become difficult to continue the high subsidies in the current budget environment.

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

The problems affecting HUD's insured Section 8 portfolio stem from several 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 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

In May, 1995 HUD proposed a mark-to-market process to address the three key problems and their causes by decoupling HUD's mortgage insurance and project-based rental subsidy programs 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.

The proposed mark-to-market process would likely affect properties differently, depending on whether their existing rents were higher or lower than market rents and on their funding needs for capital items, such as deferred maintenance. 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.

After reviewing HUD's proposal, various stakeholders raised questions and concerns about the proposal, including the effect that it would have on different types of properties and residents, and the long-term financial impact of the proposal on the government. In response to stakeholders' concerns, HUD made several changes to its proposal and also renamed the proposal "portfolio reengineering." The changes HUD made 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 into account the tax consequences related to debt forgiveness for property owners who enter into restructuring agreements. More recently, HUD has also suggested that action should be deferred on properties that would not be able to generate sufficient income to cover operating expenses after reengineering until strategies are developed that address the communities' and residents' needs relating to the properties.

On April 26, 1996, HUD received legislative authority to conduct a demonstration program to test various methods of restructuring the financing of properties in the insured Section 8 portfolio.[3] Participation in the program is voluntary and open only to properties that have rents which exceed HUD's fair market rent (FMR) for their locality.[4] The purpose of the demonstration is to test the feasibility and desirability of properties meeting their financial and other obligations with and without FHA insurance, with and without above-market Section 8 assistance, and using project-based assistance or, with the consent of the property owner, tenant-based assistance. The demonstration program is limited by law to mortgages covering a total of 15,000 units or about 2 percent of the total units in the insured Section 8 portfolio. An appropriation of $30 million was provided to fund the cost of modifying loans under the program, which remains available until September 30, 1997. HUD believes that this funding level could limit the number of properties that can be reengineered under the demonstration. On July 2, 1996, HUD issued a public notice announcing the program and providing initial guidance on how it plans to operate the program.

On May 21, 1996, the Senate Committee on Banking, Housing, and Urban Affairs issued a Staff Discussion Paper to outline a general strategy for addressing the problems with HUD's insured Section 8 portfolio. Among other things, the staff proposed to continue project-based Section 8 assistance and to subsidize rents at 90 percent of FMR (or at higher budget-based rents in certain cases if the FMR-based rents would not

[3]Authority for the demonstration program was provided in Section 210 of HUD's Appropriations Act for 1996 (P. L. 104-134).

[4]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 tenant-based rent subsidies.

cover the costs of operation). On June 27, 1996, the Subcommittee on Housing Opportunity and Community Development held a hearing on the staff's proposals, and as of mid-July the Subcommittee was drafting a restructuring bill.

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[5] 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.[6] 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 the 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 underway. 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.

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

[6]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.

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.[7] Specifically, Ernst & Young's study estimates that a 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 the 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.[8]

[7]The study defines capital needs as the cost of improvements needed to bring properties into adequate physical condition to attract uninsured market rate financing. Three categories of capital needs are defined: (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 or fewer years; and (3) long-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in more than 5 years.

[8]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.

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.

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 toward 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 the Ernst & Young 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.[9] 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 the 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.

[9]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 Ernst & Young's report on the results of its study.

Complex Issues Will Shape the Potential Outcomes of Reengineering

As we discussed in our testimony before this Subcommittee last year, the Congress faces a number of significant and complex issues in evaluating HUD's portfolio reengineering proposal.[10] Since last year there has been considerable discussion on the issues we noted, but there is still disagreement on how many of them should be addressed. New issues have also been raised. Key issues include the following.

How to Address HUD's Problems in Managing the Insured Section 8 Portfolio

One key cause of the current problems affecting the insured Section 8 portfolio has been HUD's inadequate management of the portfolio. HUD's original proposal sought to address this situation by subjecting properties to the disciplines of the commercial market by converting project-based subsidies to tenant-based assistance, adjusting rents to market levels, and refinancing existing insured mortgages with smaller, uninsured mortgages if necessary for properties to operate at the new rents. However, to the extent that the final provisions of reengineering perpetuate the current system of FHA insurance and project-based subsidies, HUD's ability to manage the portfolio will remain a key concern. Thus, it will be necessary to identify other means for addressing the limitations that impede HUD's ability to effectively manage the portfolio, particularly in light of the planned staff reductions that will further strain HUD's management capacity.

To What Extent Should FHA Insurance Be Provided for Restructured Loans

An issue with short-term—and potentially long-term—cost implications is whether HUD should continue to provide FHA insurance on the restructured loans and, if so, under what terms and conditions. If FHA insurance is discontinued when the loans are restructured as originally planned, HUD would likely incur higher debt restructuring costs because lenders would set the terms of the new loans, such as interest rates, to reflect the risk of default that they would now assume. The primary benefits of discontinuing insurance are that (1) the government's dual role as mortgage insurer and rent subsidy provider would end, eliminating the management conflicts associated with this dual role, and (2) the default risk borne by the government would end as loans were restructured. However, the immediate costs to the FHA insurance fund would be higher than if insurance, and the government's liability for default costs, were continued.

[10] Multifamily Housing: HUD's Proposal to Restructure Its Portfolio (GAO/T-RCED-95-226, June 13, 1995).

If, on the other hand, FHA insurance were continued, another issue is whether it needs to be provided for the whole portfolio or could be used selectively. For example, should the government insure loans only when owners cannot obtain reasonable financing without this credit enhancement? Also, if FHA insurance were continued, the terms and conditions under which it is provided would affect the government's future costs. Some lenders have indicated that short-term (or "bridge") financing insured by FHA may be needed while the properties make the transition to market conditions, after which time conventional financing at reasonable terms would be available. Thus, the government could insure loans for 3 to 5 years, in lieu of the current practice of bearing default risk for 40 years. Finally, the current practice of the government's bearing 100 percent of the default risk could be changed by legislation requiring state housing finance agencies or private-sector parties to bear a portion of the insurance risk.

Should Rental Assistance Be Project-Based or Tenant-Based

In addressing the problems of the insured Section 8 portfolio, one of the key issues that will need to be decided is whether to continue project-based assistance, convert the portfolio to tenant-based subsidy, or use some mix of the two subsidy types. On one hand, the use of tenant-based assistance can make projects more subject to the forces of the real estate market, which can help control housing costs, foster housing quality, and promote resident choice. On the other hand, by linking subsidies directly to property units, project-based assistance can help sustain those properties in housing markets that have difficulty in supporting unsubsidized rental housing, such as inner-city and rural locations. In addition, residents who would likely have difficulty finding suitable alternative housing, such as the elderly or disabled and those living in tight housing markets, may prefer project-based assistance to the extent that it gives them greater assurance of being able to remain in their current residences.

What Protection Should Be Given to Households at Reengineered Properties

If a decision is made to convert Section 8 assistance from project-based to tenant-based as part of portfolio reengineering, decisions must also be made about whether to provide additional displacement protection for current property residents. HUD's April 1996 reengineering strategy contains several plans to protect the residents affected by rent increases at insured properties. For example, the residents currently living in project-based Section 8 units that are converted to tenant-based subsidy would receive enhanced vouchers to pay the difference between

30 percent of their income and the market rent for the property in which they live, even if it exceeds the area's fair market rent ceiling. The residents of reengineered properties who currently live in units without Section 8 subsidy would receive similar assistance if the properties' new rents require them to pay more than 30 percent of income. Such provisions are clearly important to help limit residents' rent burdens and reduce the likelihood of residents being displaced, but they also reduce Section 8 savings, at least in the short run. The Ernst & Young study's cost estimates assume that HUD would cover Section 8 assistance costs for existing residents, even if a property's market rents exceed fair market rent levels set by HUD. However, it does not include any costs for providing Section 8 subsidy to residents who are currently unassisted.

To What Extent Should Properties With Assisted Rents Below Local Market Rents Be Included in Portfolio Reengineering

The decision about which properties to include in portfolio reengineering will likely involve trade-offs between addressing the problem of high subsidy costs and addressing the problems of poor physical condition and exposure to default. On one hand, reengineering only those properties with rents above market levels would result in the greatest subsidy cost savings. On the other hand, HUD has indicated that also including those properties with rents currently below market levels could help improve these properties' physical and financial condition and reduce the likelihood of default. However, including such properties would decrease estimated Section 8 subsidy cost savings. Although HUD's latest proposal would initially focus on properties with rents above market, it notes that many of the buildings with below-market rents are in poor condition or have significant amounts of deferred maintenance which will need to be addressed at some point.

What Process or Processes Should Be Used to Restructure Mortgages

Selecting a mortgage restructuring process that is feasible and that balances the interests of the various stakeholders will be an important, but difficult, task. Various approaches have been contemplated, including payment of full or partial insurance claims by HUD, mortgage sales, and the use of third parties or joint ventures to design and implement specific restructuring actions at each property. Because of concerns about HUD's ability to carry out the restructuring process in house, HUD and others envision relying heavily on third parties, such as State Housing Financing Agencies (HFAS) or teams composed of representatives from HFAS, other state and local government entities, nonprofit organizations, asset managers, and capital partners. These third parties would be empowered to act on HUD's behalf, and the terms of the restructuring arrangements that they work out could to a large extent determine the costs to, and future effects of restructuring on, stakeholders such as the federal government, property owners and investors, mortgage lenders, residents, and state and local government housing agencies. Some, however, have questioned whether third parties would give adequate attention to the interests of owners or to the public policy objectives of the housing. On the other hand, with the proper incentives, third parties' financial interests could be aligned with those of the federal government to help minimize claims costs.

To What Extent Should the Federal Government Finance Rehabilitation Costs

Who should pay for needed repairs, and how much, is another important issue in setting restructuring policy. As discussed previously, Ernst & Young's study found a substantial amount of unfunded immediate deferred maintenance and short-term capital replacement needs across the insured Section 8 portfolio, but particularly in the "older assisted" properties. Ernst & Young's data indicate that between 22 and 29 percent of the properties in the portfolio could not cover their immediate deferred maintenance and short-term capital needs, even if their mortgage debt were fully written off. HUD proposes that a substantial portion of the rehabilitation and deferred maintenance costs associated with restructuring be paid through the affected properties' reserve funds and through FHA insurance claims in the form of debt reduction. Others have suggested that HUD use a variety of tools, such as raising rents, restructuring debt and providing direct grants, but that per-unit dollar limits be set on the amount that the federal government pays, with the expectation that any remaining costs be paid by the property owners/investors or obtained from some other source.

How Should HUD Address the Large Number of Properties That Would Have Difficulty Sustaining Operations

According to Ernst and Young's assessment, between 22 and 29 percent of HUD's insured portfolio would have difficulty sustaining operations if market rents replaced assisted rents. Furthermore, between 11 and 15 percent of the portfolio would not even be able to cover operating costs at market rents. If additional financial assistance is not provided to these properties, a large number of low-income residents would face displacement. While HUD has not yet developed specific plans for addressing these properties, it appears likely that different approaches may be needed, depending on a property's specific circumstances. For example, properties in good condition in tight housing markets may warrant one approach, while properties in poor condition in weak or average housing markets may warrant another. Further analysis of these properties should assist the Department in formulating strategies for addressing them.

To What Extent Should the Government Provide Tax Relief to Owners Affected by Portfolio Reengineering

HUD's portfolio reengineering proposal is likely to have adverse tax consequences for some project owners. These tax consequences can potentially result from either reductions in the principal amounts of property mortgages (debt forgiveness) or actions that cause owners to lose the property (for example, as a result of foreclosure). We have not assessed the extent to which tax consequences are likely to result from portfolio reengineering. However, HUD has stated that it believes tax consequences can be a barrier to getting owners to agree to reengineer their properties proactively. While HUD has not formulated a specific proposal for dealing with the tax consequences of portfolio reengineering, it has stated that it is willing to discuss with the Congress mechanisms to take into account tax consequences related to debt forgiveness for property owners who enter into restructuring agreements.

Will the Demonstration Program Cover the Full Range of Options and Outcomes

The multifamily demonstration program that HUD recently received congressional authority to implement provides for a limited testing (on up to 15,000 multifamily units) of some of the aspects of HUD's multifamily portfolio reengineering proposal. As such, the program can provide needed data on the impacts of reengineering on properties and residents, the various approaches that may be used in implementing restructuring, and the costs to the government before a restructuring program is initiated on a broad scale. However, because of the voluntary nature of the program, it may not fully address the broad range of impacts on the properties or the range of restructuring tools that the Department could use. For example, owners may be reluctant to participate in the program if HUD plans to enter into joint ventures with third-party entities because of concerns they may lose their properties and/or suffer adverse tax consequences. Another potential limitation on the program is that the funding provided to modify the multifamily loans may not be sufficient to cover the limited number of units authorized under the demonstration program.

How these issues are resolved will, to a large degree, determine the extent to which the problems that have long plagued the portfolio are corrected and prevented from recurring and the extent to which reengineering results in savings to the government.

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 the federal government has continued to subsidize the rents at many properties above the level that the properties could command in the commercial real estate market.

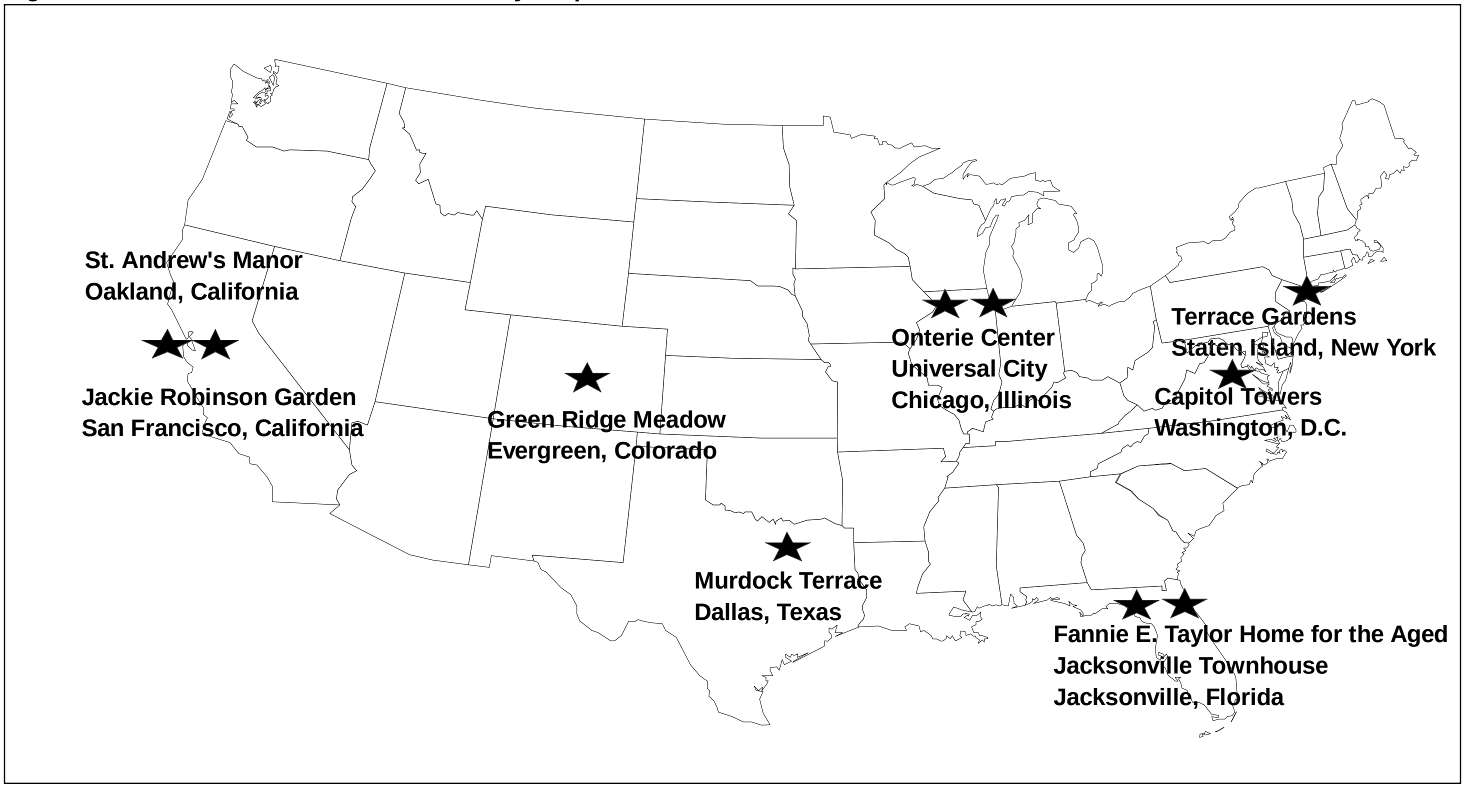
As the Congress evaluates options for addressing this situation, it will be important to consider each of the fundamental problems that have affected the portfolio, and their underlying causes. Any approach implemented should address not only the high Section 8 subsidy costs, but also the high exposure to insurance loss, poor physical condition, and the underlying causes of these long-standing problems with the portfolio. As illustrated by several of the key issues discussed above, questions about the specific details of the reengineering process, such as which properties to include and whether or not to provide FHA insurance, will require weighing the likely effects of various options and the trade-offs involved when proposed solutions achieve progress on one problem at the expense of another. Changes to the insured Section 8 portfolio should also be considered in the context of a long-range vision for the federal government's role in providing housing assistance, and assistance in general, to low-income individuals, and how much of a role the government is realistically able to have, given the current budgetary climate.

Addressing the problems of the portfolio will inevitably be a costly and difficult process, regardless of the specific approaches implemented. The overarching objective should be to implement the process in the most efficient and cost-effective manner possible, recognizing not only the interests of the parties directly affected by restructuring but also the impact on the federal government and the American taxpayer.

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.

GAO's 10 Case Study Properties

Figure 1: Names and Locations of Case Study Properties



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