DOCUMENT RESUME

05706 - [B1146096]

Section 236 Rental Housing: An Assessment of HUD's Comments on GAO's Evaluations. PAD-78-62; B-171630. April 20, 1978. 7 pp. + 4 appendices (42 pp.).

Report to Sen. William Proxmire, Chairman, Senate Committee on Appropriations: HUD-Independent Agencies Subcommittee; by Elmer B. Staats, Comptroller General.

Issue Area: Domestic Housing and Community Development: Housing for Low and Moderate Income Families (2101); Domestic Housing and Community Development: Federal Credit Incentives to Stimulate Housing (2104);Program Evaluation Systems (2600).
Contact: Program Analysis Div.
Budget Function: Community and Regional Development: Community Development (451); Commerce and Transportation: Mortgage Credit and Thrift Insurance (401); Income Security: Public Assistance and Other Income Supplements (604).
Organization Concerned: Department of Housing and Urban Development; Office of Management and Budget.
Congressional Relevance: House Committee on Banking, Currency and Housing; Senate Committee on Banking, Housing and Urban Affairs; Senate Committee on Appropriations: HUD-Independent Agencies Subcommittee. Sen. William Proxmire.
Authority: H.R. 17989 (90th Cong.). S. 3497 (90th Cong.).

A report issued in January 1978 comprehensively evaluated the section 236 rental assistance program and made recommendations to the Congress and the Department of Housing and Urban Development (HUD) which would assure that moderate income households receive a reasonable share of future housing assistance. The report concluded that the section 236 program had been successful in producing quality housing units in record numbers and in providing this housing to a tenant group drastically different from the very low income households aided by conventional public housing programs or by the section 8 leasing program. The report recommended that HUD take measures to see that moderate income households receive an equitable share of Federal housing assistance and that section 236 be reactivated until a preferable alternative is developed. Findings/Conclusions: HUD shared the view that the program was an effective means of assisting a segment of the housing poor. However, they felt that the inflexibility of the section 236 subsidy mechanism which tied payments to the mortgage debt, in combination with general multifamily insurance problems, undermined the long term economic viability of section 236. The Department noted that it was exploring other methods to aid moderate income households and agreed that HUD had a responsibility to respond to the housing needs of the entire range of the housing deprived. Current housing policy includes nothing for this income group. In the meantime, the supply of

moderately priced rentals continues to shrink. The January 1978 report also noted that the long term costs of housing programs are often inadequately analyzed, particularly the long term subsidy costs of leasing existing units under section 8. Recommendations: The Secretary of HUD should: develop criteria for judging the performance of multifamily insurance programs and procedures for screening out unacceptable risks; provide the Congress with an understandable analysis of past program mortgage failures; evaluate new Federal Housing Administration insurance programs or program changes in terms of likely insurance losses; and suspend commitments for nonprofit, cooperative, and rehabilitation projects until they have the capability to screen out unacceptable risks. (HRS)

6096

REPORT BY THE

Comptroller General

OF THE UNITED STATES

Section 236 Rental Housing: An Assessment Of HUD'S Comments On GAO'S Evaluations

In an earlier report GAO evaluated the section 236 rental housing program. Its effectiveness, impact and costs were compared to other housing programs. GAO found the program successful and recommended steps to assure that moderate income households receive some share of future housing assistance.

The Department's comments, which were received too late for inclusion in that report, rejected the most important GAO recommendations, but failed to alter GAO's position.

This report summarizes the conclusions and recommendations of GAO's earlier report and replies to the Department's comments.

PAD-78-62

APRIL 20, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-171630

The Honorable William Proxmire
Chairman, Subcommittee on Housing and Urban
Development and Independent Agencies
Committee on Appropriations
United States Senate

Dear Mr. Chairman:

On January 10, 1978, we issued a report entitled, "Section 236 Rental Housing--An Evaluation With Lessons for the Future" (PAD-78-13). The report comprehensively evaluated the section 236 rental assistance program and made recommendations to the Congress and the Department of Housing and Urban Development (HUD) which would assure that moderate income households receive a reasonable share of future housing assistance. We also recommended that the Department improve the way it analyzes subsidy costs and mortgage failures and stop insuring loans for certain high risk multifamily housing projects (nonprofits and rehabilitations), until methods are developed for screening out unacceptable risks (see app. IV).

We issued the report without Department comments because they were unable to respond within 90 days. We did receive their comments before publication, but it was too late to incorporate them as the report was ready for printing. The comments were extensive and rejected our most substantive recommendations, but they did not alter our position or necessitate changes in the report. Therefore, we issued the report without the Department's comments rather than delay publication any further.

The report concluded that the section 236 program had been successful in producing quality housing units in record numbers, and in providing this housing to a tenant group drastically different than the very low income households aided by the conventional public housing program or by the newer section 8 leasing program. These households, which have somewhat higher incomes, are nonetheless unable to afford decent housing in the market place without some assistance (see app. III for a summary of the January report). We noted that this group was largely excluded from housing assistance by the section 236 suspension.

We recommended that HUD take measures to see that moderate income households receive an equitable share of Federal housing assistance, and that section 236 be reactivated until some clearly preferable alternative is developed.

MODERATE INCOME HOUSING POLICY

The Department shared our view that the program was an effective means of assisting a segment of the housing poor. However, they felt the inflexibility of the section 236 subsidy mechanism which tied payments to the mortgage debt and therefore could not accommodate operating cost increases, in combination with more general multifamily insurance problems, undermined the long term economic viability of section 236. This overlooks the fact that the Congress enacted a law authorizing an operating subsidy when this problem was discovered, which HUD refused to implement although it was probably clear that this refusal would cause some otherwise viable projects to fail. This operating subsidy is still available and would make section 236 feasible today. It is true that this is a backhanded way of providing a deeper subsidy, but it has the virtue of targeting rents at moderate income tenants, since tenants must pay a significant share of the total rent. Section 8 really provides an operating subsidy directly but has no mechanism for targeting housing assistance. The recipients are chosen by the developers or local housing authorities within broad guidelines which make a large percentage of the U.S. population eligible. Although we did not explicitly make the point in the draft which HUD reviewed, we were assuming that the program would be reactivated in its present form with all subsequent amendments and that necessary administrative changes would be made. This includes implementing the operating cost provision. A similar operating cost subsidy has been enacted and implemented for public housing. It has a payment mechanism not unlike section 236 and it seems to be working.

The Department also said that it was exploring other methods to aid moderate income households. They agreed with us that the Department had "a responsibility to respond to the housing needs of the entire range of housing deprived." The Department did propose a new subsidy for the working poor last year. It would have had "minimum" income limits and a simpler processing procedure, much like section 236. The program would have been targeted at that income group just above public housing eligibility, but it did not appear in the budget, and would have been for a relatively small number of units anyway.

The January report also suggested that if the Congress wanted to make sure that some housing assistance goes to moderate income households, it could provide additional funding to section 236 and amend the present housing law to require some percentage of new housing assistance to be used for moderate income housing.

In the earlier draft which HUD reviewed, we did not suggest additional funding. HUD interpreted this to mean that we were recommending that funds be diverted from lower income households in order to assist moderate income households. This was not our intention, but it is important to reiterate that moderate income tenants are presently receiving virtually no additional housing assistance, while the very poor are receiving the bulk of the roughly 400,000 unit housing subsidies planned for each of the recent budget years. And middle and upper income households receive yearly tax subsidies in excess of $10 billion through the deductibility of interest and property taxes against taxable income. The net effect of this kind of housing policy is that subsidized poverty households can afford high quality apartments at nominal rents, while unsubsidized moderate income households pay a high percentage of income for rent on substandard housing, and upper income families receive a substantial subsidy for luxury housing. This policy was originally forged on the assumption that adequate housing production would create a surplus in the housing stock, and standard quality units would filter down to those not otherwise covered by the U.S. housing policy. This surplus did not materialize, and section 236 was designed to give some relief to this group.

The current housing policy includes nothing for this income group but the possibility that newly constructed section 8 housing may eventually provide help. It will be some time before this can be adequately demonstrated. In the meantime, the supply of moderately priced rentals will continue to shrink, and moderate income households will continue to bear an inordinate share of the Nation's housing shortage.

The set aside which we suggested for moderate income assistance would not alleviate moderate income need entirely. It could conceivably deny some assistance to very low income families, but it would help correct a serious flaw in the Nation's housing strategy by taking some pressure off the moderately priced rental market and correcting an anomalous situation. In essence, the Department admits there is a need to aid moderate income households, rejects our recommendations for assisting moderate income households, and offers no alternatives.

HOUSING COSTS

We also noted in the January report that the long term costs of housing programs are often inadequately analyzed. In particular we noted that the long term subsidy costs of leasing existing units under section 8 (or providing housing allowances which are similar in many respects), have never been adequately compared to the costs of new construction programs such as public housing or section 8 construction.

This is particularly disturbing, since there is reason to believe that providing housing allowances or section 8 subsidies to existing rental units may be more expensive in the long run than providing new construction subsidies. These alternatives clearly look cheaper in the short run as compared to new construction subsidies. But their costs may increase more rapidly in the future since subsidies are tied to prevailing rent levels. Most new construction subsidies allow the Federal Government considerable control over the magnitude of the subsidy for many years. We therefore recommended that the Secretary of Housing and Urban Development undertake a careful comparison of the long term costs of these alternatives and provide the results to the Congress.

Since the Department's housing policy has been heavily weighted toward leasing in recent years, and since this could, if pursued indefinitely, cause a further decline in rental housing production and perhaps unnecessary inflation in rents and consequently in rent subsidies, we suggested that Congress consider requiring that housing funds be expended to balance existing housing subsidies with new construction subsidies. We felt this would minimize the risk of pursuing a strategy detrimental to either the supply or the cost of housing. The Department made no comment on this suggestion.

The Department stated that it had been making such cost comparisons for many years and that they would continue to seek improvement in their methodology and data, but cautioned that the comparative technique which we suggest is only one criteria for analyzing housing programs.

We are of course aware of the various cost analyses made by the Department over the years. The thoroughness of these has ranged from comprehensive to cursory, but regardless of their quality, such estimates are not routinely prepared on a life cycle basis for new programs before implementation. Furthermore, comparisons provided to the Congress have generally been of limited quality. What the Congress usually sees are first year direct subsidy costs on a program-by-program basis. When indirect costs such as tax subsidies are included, they are provided for the first year only and the estimating methodology may vary from program to program making comparisons dangerous. There is little attention given to presenting alternatives which are equally effective. These factors and other problems limit the value of cost comparisons to congressional decisionmakers. We agree with the Department's contention that cost is only one criterion on which to judge a program. Our January report looked at many other criteria such as impact, effectiveness and equity. The cost chapter was one of twelve in the report, and we found that public housing was probably less expensive, but other factors led us to conclude that section 236 was successful and worthy of continuation.

FEDERAL HOUSING ADMINISTRATION MORTGAGE INSURANCE FAILURES

Our report also put heavy emphasis on the analysis of mortgage insurance failures under section 236, and other multifamily housing programs. We observed that the mortgage default and failure problem under section 236 was not as serious as often claimed. Some risk is necessary in any insurance program, and the Federal Housing Administration was set up to take risks private insurers would not. This was done to induce added production. What has been missing is a perspective on what risks the Federal Housing

Administration should take, and those which it should avoid. Profit-motivated section 236 sponsors appear to have an acceptable failure experience in terms of both numbers and cost of failures, whereas nonprofits, cooperatives, and rehabilitations may be too expensive and troublesome. The Federal Housing Administration has in the past taken virtually any risk which met certain tests, while private lending institutions and insurers have taken very little risk.

What the Federal Housing Administration should do is undertake projects involving reasonable risks as judged by the expected production, financial losses, and administrative burden. However, there has been serious difficulty in identifying these reasonable risks. In spite of HUD's experience with past multifamily programs, the Department plans to devote nearly three quarters of its 1978 construction commitments under section 8 to nonprofit sponsors and rehabilitation projects. Our work on mortgage failures helps increase understanding of insurance programs, but additional and more focused information is needed. Until such information is developed, HUD needs to modify its policy for insuring subsidized projects.

We therefore recommended that the Secretary of Housing and Urban Development

--develop criteria for judging the performance of multifamily insurance programs and procedures for screening out unacceptable risks,

--provide Congress with an understandable analysis of past Federal Housing Administration program mortgage failures,

--evaluate new Federal Housing Administration insurance programs or program changes in terms of likely insurance losses, and

--suspend commitments for nonprofit, cooperative, and rehabilitation projects until they have the capability to screen out unacceptable risks.

The Department agreed that they needed to better understand the factors which make some projects more risky than others, and said they would conduct a thorough study of multifamily default risk.

They said that the results of this study would be used to analyze past failure experience and to evaluate future Federal Housing Administration insurance programs. But they did not agree with the recommendation to suspend commitments for nonprofits, cooperatives and rehabilitated projects. No reason for this disagreement was given except for a reference to "the Department's overall experience with cooperative housing, which has demonstrated a very low default rate."

We could find no data to support this contention. A recent Department survey showed that 21 percent of cooperative projects (under all HUD programs) were considered troubled by HUD as compared to 27 percent of nonprofits and only 12 percent of profit-motivated projects. Recent data on section 236 program mortgage failures show a similar comparison. We therefore feel that our recommendation to suspend commitments on the more risky classes of projects is still warranted.

Our evaluation of the Department's more detailed comments are in appendix I. HUD's comments on the January report are in appendix II. A synopsis of our January report and the recommendations we made at that time are in appendices III and IV.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

EVALUATION OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT'S COMMENTS ON GAO JANUARY 10, 1978, REPORT

The Department of Housing and Urban Development's (HUD's) comments on our January 10 evaluation of section 236 rental assistance was divided into three basic sections--an overall summary, comments on our major recommendations, and other comments which were more technical in nature. The first two parts of their response were analyzed in the body of this letter report. This appendix reproduces HUD's other comments verbatim with our evaluation immediately following each point. It also responds in a general sense to some recurring themes in the Department's comments.

DEPARTMENT COMMENTS ON LEGISLATIVE HISTORY

In several respects we believe the proposed GAO Report is incorrect in its interpretation of Section 236 history and experience. One such area is the question of what income group the program was designed to serve. The proposed report argues that Section 236 was intended to serve moderate income households. This thesis is not correct. As originally proposed, Section 236 was intended for moderate income households. However, the Congress rejected this as a sole orientation and specifically altered the eligibility formula to focus the program on lower income households. The original Section 236 proposal submitted in 1968 by President Johnson to Congress was designed to achieve a high volume of production by aiming at moderate income households. In response to a query as to why lower income limits were not used, Secretary Weaver answered:

> By having the more liberal upper limits, you have the possibility of getting a greater volume quicker and also of providing relatively small subsidies to those who need less help but still need some help in order to obtain decent housing.

But Congress did not accept this proposal. The Senate cut the income limits to 70 percent of local median income, for 80 percent of the funds. The remaining 20 percent of the funds could be provided for families that exceeded these limits. It simultaneously allowed a $300 deduction for each minor child. Republican Senators were critical, with Senators

Bennett, Tower, and Hickenlooper stating: "To allow that 46 percent, or, almost half, of our Nation's families must be supported by their government, is certainly not acceptable in our opinion."

The House was not satisfied by the rollback of the regular income limits to 70 percent of median income, and cut back the maximum permissible income even farther--to a figure representing 130 percent of the income that would make one eligible for public housing admission. A Senate-House Conference Committee finally settled on a 135 percent figure.

The mixture of a lower limit while retaining the original subsidy level was seen as a problem by knowledgeable Congressmen and the prestigious President's Committee on Urban Housing (The Kaiser Committee). Representative Reuss felt that the program as designed would serve "paupers plus 30 percent." Representative Barrett, the Chairman of the House of Representatives' Subcommittee on Housing, felt that the amendments would "cripple the program." In its report, A Decent Home, the Kaiser Committee combined both complaints:

> Congress has often unwittingly undermined the feasibility of these programs by imposing income limits for eligibility which are too low given the maximum subsidy provided. If only a small subsidy is provided, but eligibility is restricted to poor families, the program will not work and private sponsors will refuse to use it. The Congressional motivation for imposing low limits for eligibility is apparently to make sure that the most needy families receive priority. This is indeed a worthy goal. But lowering eligibility limits without at the same time increasing the depth of the subsidy, in effect, squeezes the life out of the program by narrowing the effective target population. It is possible, for example, that Congress has seriously damaged the 235 Homeownership program and 236 Rental program by imposing income limits too low for the subsidy available.

GAO EVALUATION

HUD characterized our report as saying that the section 236 program "was intended to serve moderate income households." It should first be pointed out that what we actually said was that section 236 was

> "aimed at moderate-income tenants or, more precisely, those households whose incomes were too high to qualify for public housing, yet too low to obtain adequate housing in the market at affordable rents."

We said that section 236 could reach low-income tenants when combined with the rent supplement program, which reached those eligible for public housing, but that since rent supplements were limited to a minority of units in a project, section 236 was still predominantly a moderate income program.

We feel the Department's discussion of this subject overlooks a number of factors or points of view which led us to describe the program as targeted primarily at moderate income households. These factors include (1) contradictions between the purpose stated during debate and the effect of the eligibility formulas of the original act and subsequent amendments, (2) the original proposals, which would have included nearly half of the population as eligible for the program and may explain the reaction of legislators who wished to serve those in genuine need, and (3) difficulty in defining just what moderate income really was. These factors are heavily intertwinded and will be discussed with and after some further recapitulation of the legislative history.

The House Committee accepted the Johnson Administration's proposal to provide rental and other housing benefits for moderate as well as lower income families. In reporting H.R. 17989, the House Committee on Banking and Currency stated:

> "A basic factor in the magnitude and urgency of our present housing problems has been the failure to include all parts of our population in the general rise in incomes and wealth."
>
> * * * * *
>
> "The bill would authorize a new program of interest subsidies in behalf of low and moderate income occupants or rental and cooperative housing (Sec. 201)." H.R. Rep. No. 1585, 90th Cong. 2d Sess. (1968) 1-2.

In its section-by-section analysis of the bill, the Committee described its subsidy program in the following language.

> "Subsection (a) adds * * * a new section 236, establishing for low and moderate income families a rental and cooperative housing assistance program, under which periodic payments will be made to the mortgagee to reduce the interest costs which the owner of a rental or cooperative project must pay from what is actually required for principal, interest, and mortgage insurance premiums under the mortgage covering the project to what would be required for principal and interest if the mortgage bore interest at the rate of 1 percent."

As reported, H.R. 17989 gave the Secretary of HUD the authority to establish tenant eligibility standards and rents. However, the rental for each dwelling unit was to be limited to no more than 20 percent of the tenant's income.

The Senate version, S. 3497, 90th Cong., as reported by the Committee on Banking and Currency, had no references to moderate income families and eligibility was limited to tenants whose incomes were not in excess of 70 percent of local median income (local median income was the standard prescribed for eligibility under section 221(d)(3) of the National Housing Act--a program that was designed to provide rental and cooperative housing for families whose incomes were too high for public housing but too low for standard housing available on the market.) However, the Senate formula would have permitted 20 percent of the contract funds to be used for families with incomes above those limits.

The Conference Committee compromise, which was enacted without change, required at least 80 percent of the total amount of interest reduction payments to be made to families whose incomes were less than 135 percent of the maximum income limits permitted for initial occupancy in public housing dwellings, plus $300 per minor child. For the remaining 20 percent of the funds, the Conference bill raised the maximum income limit of families at the initial time of renting from 70 percent to 90 percent of the limits prescribed for occupants of projects financed under section 221(d)(3), plus $300 for each minor child. As with the Senate bill, the Conference bill made no mention of "moderate income" families but required the Secretary to administer the limitations "so as to accord a preference to those families whose incomes are within the lowest practicable limits for obtaining rental accommodations in projects assisted under this section."

Senator Sparkman, in presenting the Conference Committee report to the Senate, described the intent of the identical section 101 eligibility formula:

> "Admittedly, this is a complex formula, but main intent is to limit the benefits of this program to families of the lower income category and, in fact, the law specifies that priority will be given, in so far as practicable, to the lowest income families who can achieve home ownership under the program."

The conflict between a desire to provide housing for low income persons and yet make it available to persons of sufficient income to make the program financially feasible appears to have resulted in a formula which, in fact, is geared to moderate as well as low income families. Senator Muskie described the rental subsidy as being designed to provide decent housing for people "within the range of $3,000 to $6,500 per year * * *."

Several Members of the House observed that the rental program could not be considered as solely for the benefit of low income families. For example, Representative Widnall, the ranking minority Member of the Banking and Currency Committee, observed that the income limits of title I, which are identical to those of the section 236 rental support program, would have allowed families making almost $11,000 in New York City, or just below $10,000 in Chicago, Detroit, Los Angeles, Boston and other cities to qualify for assistance. He concluded:

> "They are not as generous in Philadelphia and other places, but still are well above the $6,000 figure cited so often in testimony by the Secretary of Housing and Urban Development as the top range in which the new program would operate. Yet HUD has made representations to the effect that it must have these higher income limits to make the program work. At any rate with income limits like these, it hardly appears to be a program for lower income families."

So that although there was some ambiguity in the debate and repeated statements, only a few of which are shown here, to the effect that the program should serve "low income" or "the lowest income" households, it was also known and accepted that the program would serve households which many legislators did not consider to be low income. The formula for eligibility itself was clearly structured to allow incomes considerably higher than those in public housing, and the section 236 program was also to be combined with rent supplement payments so that it could serve "very low income" tenants. Carl A. S. Coan, Jr., who was the assistant General Counsel for legislative Policy Coordination at HUD during the passage of the 1968 act, described section 236 after it was passed as, "achieving a broader income spread from the lower income range up through the moderate-income range."

Although no clear definition of moderate income really exists, housing researchers have frequently referred to the section 236 program as a moderate income program. Moderate income households have been defined variously as (1) those households above the poverty level who are nonetheless unable to afford standard housing without assistance (in 1969 just after passage of section 236, the poverty level was set at $3,721 per year for a 4 person household), (2) $4,400-$8,000 household income per year, and (3) $5,000-$10,000 household income per year. By any of these definitions, the majority of households served by section 236, at the time of passage and today, could be considered moderate income. When the program was just getting started in 1972, only 9 percent of households in section 236 housing were below the poverty level. The formula adopted in the law allowed occupancy by families ranging up to more than $10,000 per year in many jurisdictions, and this formula combined with the subsidy mechanism virtually assured that households would have considerably higher income than either poverty households or those in the low rent public housing program.

We concluded that at the time of the congressional debate on the 1968 act, there was a general concern that those households to be helped by sections 235 and 236 should be in genuine need. This caused the changes in the eligibility formula which excluded those at the higher end of the moderate income range. But Congress still realized that it was allowing the eligibility of, and in fact targeting the program at, an income group generally above that served by public housing.

HUD COMMENT ON THE DISTRIBUTION OF BENEFITS

In many respects, the proposed GAO Report will be a significant contribution to the study of subsidized housing programs. Because it will become a document which will be frequently cited, it is important to high-light any differences in the approach to analyzing subsidized housing programs which we perceive.

In assessing the performance of the Section 236 program reference is made frequently to the ratio of subsidized units to target population. It is argued that the income eligible population is not the correct target population. This is difficult to accept. The Congress established income and family status as the only tests of admission. Unlike public housing, no special preference was given to families displaced in the process of urban renewal or with a veteran. The exclusion of homeowners from the target population is particularly arbitrary.

Even if a more limited definition of the target population were acceptable, there would still be a problem with the analysis because GAO made adjustments only to the denominator of the ratio and not the numerator. In other words, Section 236 can be said to serve the moderate income renter population which is inadequately housed only to the extent to which it draws its actual tenants from this population. Failure to make similar adjustments in the numerator results in the table on page 60 which clearly seems to imply that there is no housing problem among inadequately housed lower-income Blacks and Spanish-Americans.

GAO EVALUATION

Housing subsidies are aimed at improving the housing situation of those who cannot easily afford good housing or are in overcrowded or substandard housing. It is our judgment that limiting our estimate of need to those who are really in need provides a much better insight into both the impact of the program and the social need for housing. Showing a large percentage of the population as income eligible without regard to their housing situation would be like suggesting that we provide enough hospital beds to accommodate all those below a certain income without regard to whether or not they need hospitalization. The income requirement for housing is not designed to provide a measure of housing need, but rather it is an administrative necessity.

The present limits in housing legislation make a large percentage of the population eligible, but no one would seriously consider trying to aid all those households, many of whom own standard quality homes, or rent them at reasonable rates. HUD's assertion that our exclusion of homeowners is arbitrary seems incredible since nearly all competent estimates of social need in the housing area exclude homeowners. HUD is now working with the Massachusetts Institute of Technology-Harvard Joint Center for Urban Studies to establish housing needs and they too make this exclusion.

HUD also argues that even if a less comprehensive definition of eligibility were accepted, our analysis is still problematical since we do not analyze the extent to which subsidized tenants are drawn from the groups which we estimate as in need. That is, section 236 tenants could have been in uncrowded good quality housing at affordable rents before moving into section 236 units. This is possible, but data on how often it occurs is limited, and it generally shows that tenants have improved their situation either physically or financially. Furthermore, most section 236 tentants are in an income group which has difficulty finding standard housing at rents which they can afford, so it seems reasonable to presume that they would be in need without this housing. Finally, it is precisely because of this problem that we avoided using percentages, and instead showed the ratio of units occupied by a certain type of tenant to the number of households in that same group who are still in need. Anomalies resulting from this type of analysis, such as the one referred to by HUD on page 60 of the January report, are unavoidable, but result not from our method of comparison but from the difficulty of obtaining reliable data on both sides of the ratio. The ratios are not meant to be exact measures of the phenomenon in question, but they show relative availability of subsidized housing from one subgroup of households to another.

DEPARTMENT COMMENT ON SUBSTITUTION EFFECT

Chapter 7 discusses the question of substitution between subsidized production and unsubsidized production. We would note that no study has documented any substitution effect in the production of multifamily housing. The study cited on page 62 which concluded that for every 100 units produced under direct government subsidies 14 units were actually added to the housing stock which would not have been added in the absence of the subsidies, dealt with single-family programs.

GAO EVALUATION

The Department is correct. We should have made this distinction. The ideas on substitution were included because the assertion is often made in magazine articles, newspaper stories and congressional testimony that subsidized production is inefficient as a housing producer, since it merely replaces private production. Though this contention is not clearly supported in the literature, particularly for multifamily construction, it is still widely held. And there is generally no distinction made between single-family and multifamily housing when this point is argued. We therefore emphasized the point that section 236 households could not compete for standard private housing, and that the redistribution of housing services was the most important aspect of the subsidy mechanism. Whether total U.S. production is greatly increased by subsidies (and we feel it is) is of secondary importance.

DEPARTMENT COMMENT ON DEFAULT ANALYSIS

In discussing the default analysis informally with GAO staff it has come to our attention that the term "cummulative failure rate" is used inconsistently in the text. The discussion and analysis in Chapter 9 are well done. I have noted above our concern about limiting the analysis of the Section 236 default experience to the 1968-1973 period. We admit the usefulness of comparing program default experience across the same periods but would point out that this leaves us substantially short of the information needed for long-run projections. HUD was criticized for combining information on different programs from different periods to project Section 236 default rates for use in cost-benefit analysis. Yet GAO is forced to use even more ad hoc procedures on page 115.

GAO EVALUATION

We corrected the confusion about the use of the term "cummulative failure rate" with regard to the chart on page 84 in the final version of our January report.

Our projections for failure related costs were based on the Department's estimates of long term failure rates. Although we pointed out that such estimates are difficult to make and that the Department's methodology was inadequate, our cost projections were based upon reasonable assumptions about how failure costs would be incurred. Our sensitivity analysis (testing the results of changed assumptions on the total cost of each alternative) showed that significant changes in the assumed failure rates would not change the relative position of the subsidy programs analyzed. We do not feel our procedures were in any sense "ad hoc." Rather they constituted the first serious attempt, which we are aware of, to address the long term costs of mortgage failures.

DEPARTMENT SUGGESTION ON TENANT ANALYSIS

The analysis in Chapter 5 v ˙ probably benefit from reemphasizing comparisons of the -al populations served across the non-elderly and elderly populations. Differences in the extent to which various programs serve these markedly different groups could make comparison of the programs on the basis of average characteristics of the total population meaningless. The frequency distributions approach should be used more frequently in this Chapter and Chapter 6 because means and medians can be misleading. The text seems to imply that there is a difference between the tables on page 59 and the top table on page 60. Mathematically the ratio of percentages differs from the ratio of units only by a constant (the number of units in the program/number in target population). Therefore, both tables should lead to the same conclusions regarding the extent to which Section 236 serves Blacks and Spanish-Americans.

GAO EVALUATION

In each case where we show elderly and non-elderly tenants together rather than separately, we felt that separate statistics would have made the same point we were illustrating. Lumping them together was done for brevity and clarity. When additional information seemed to be added or some essential qualification illustrated, we treated the two groups separately.

The same kind of argument pertains to our use of means and medians. Measures of central tendency clearly have limitations. But in each case we started our analysis with frequency distributions and asked ourselves whether the distribution could be simplified (fewer n-tiles) or whether a mean or median could impart the information more clearly without distortion. Where such simplification was considered misleading or where the frequency distribution seemed to provide additional useful information, we kept the distribution. When the mean or median seemed clearer and there was no loss of communication, we substituted these.

Regarding the tables on page 60, we checked the work papers for these tables and found that the two tables are calculated on two distinctly different sets of numbers, which do not "vary by only a constant." A more careful reading makes this clear.

DISCUSSION OF DEPARTMENT OBSERVATION ON FINANCIAL SOUNDNESS

The Department repeatedly observes that the section 236 program was productive, that it did aid those in housing need and accomplish other things, but that due to its subsidy mechanism it was inherently unsound financially. It could not be expected to provide housing in a manner which overcomes long term management problems.

We feel that like all multifamily housing (both private and subsidized) section 236 development was and is an extremely risky venture. But as we observed in our January report, those projects which were exceptionally risky were, as classes, easily identifiable. Nonprofit sponsored projects and rehabilitations were far riskier and had far greater failure rates than those projects developed by profit motivated (limited dividend) sponsors. A reasonable modification of the subsidy to accommodate operating cost increases, which has already been provided by the Congress and which could be further modified if necessary, would further reduce the risk and enhance long term fiscal success.

Section 236 as originally developed was considered to display a genius for design since the initial subsidies would seem less and less important each year as inflation decreased the relative magnitude of the cost and as tenants who were expected to be upwardly mobile became gradually able to pay higher and higher rents. That this did not occur should not obscure the thoughtfulness of the basic approach but rather the failure to allow for the unexpected increases in operating costs related to double digit inflation. The Congress altered this approach by providing an operating subsidy for section 236 which would in our most recent economic history have been necessary for much more affluent tenants than those residing in section 236 housing. HUD, until recently, refused to use this subsidy and probably caused additional failures. This however is still not as troublesome as the initial decision to continue funding nonprofit sponsors under section 236 although history with other insurance programs pointed to much greater failures under nonprofit sponsorship (and rehabilitations). The present administration at HUD seems equally resolute in its insistence on underwriting projects which have a high probability of being unsound (70 percent of the units which HUD plans to insure during fiscal year 1978 are either nonprofits or rehabilitations). It is reasonable to assume that had the operating subsidy been initiated and nonprofit and rehabilitated projects been avoided, then the record of section 236 would have been exemplary. To this date, profit motivated section 236 projects have the best failure record of any multifamily program which HUD has insured (see pages 84 and 85 of our Janaury report).

It is also interesting to note that public housing has the same type of inflexible subsidy mechanism tied to the debt service as the section 236 program and that it too requires an operating subsidy, but is still the most cost effective way of providing multifamily rental housing which has been developed. HUD's assertion that the long term management problems of multifamily housing are not adequately addressed by section 236 is not particularly pertinent, since we know of no substantial improvements under section 8 which would not also apply to the management of section 236.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

ASSISTANT SECRETARY FOR
POLICY DEVELOPMENT AND RESEARCH

DEC 15 1977

IN REPLY REFER TO

Mr. Henry Eschwege
Director, Community and
Economic Development Division
General Accounting Office
441 G Street, N.W. (Room 6146)
Washington, D.C. 20548

Dear Mr. Eschwege:

Secretary Harris has asked me to respond to your letter of August 31 and to provide comments on the recommendations and analysis in the August 18, 1977 draft of the proposed GAO report on the Section 236 program. This response consists of a general summary of our major comments, and a more detailed analysis of both the specific findings and methodology of the report.

Summary

The Department shares the general view that the Section 236 program was an important assisted housing program for a segment of the housing poor. Had it been allowed to continue, a large number of reasonably well constructed, modest cost housing would have been added to the Nation's housing stock. The subsidy structure of Section 236, however, does not provide sufficient resources to meet the financial demands of its target populations. The ramifications of this specific deficiency, combined with more general problems which have plagued multifamily insurance programs, are becoming clear in the longer term experience of the projects.

HUD agrees that the Department has a responsibility to respond to the housing needs of the entire range of housing deprived. We are studying ways to serve the moderate income market more efficiently than proved possible with the Section 236 program. However, we do not believe that the Section 236 program as currently structured, without improvements to increase the prospect for long-term economic viability, is a fiscally sound program.

2

As ultimately enacted, Section 236 had a narrow income eligibility band tied to public housing income limits and a fixed debt service subsidy, which could not accommodate rising operating costs. This financial vulnerability was aggravated by (1) the overestimating of income and underestimating of expenses which did occur in some areas, contrary to the Department's policy, and (2) the unexpectedly high escalation of utility costs resulting from the energy crisis. Thus, a subsidy limited to a portion of debt service proved to be insufficient to bridge the gap between rapidly rising project rents and tenants' ability to pay. The increasing default totals (16 percent of all Section 236 projects are in the troubled inventory) and the need for Section 8 and operating subsidies attest to the problem of a flat subsidy in the face of rising operating costs. On the other hand, Section 236 could be viewed as fairly successful, as the Report notes, in the sense that the program did result in the production of a large number of housing units in a short period of time. In addition, 84 percent of the projects have not defaulted, although we expect that more of them will default in the future if not provided with additional subsidy assistance.

Finally, the Section 236 program shares with other multifamily insurance programs a failure to fully address long-term management needs in the production of assisted housing. Field studies of troubled projects have indicated that inadequate management is one of the significant factors in project decline and default.

It should be noted at this point that the problems of inadequate control over development costs and insufficient attention to operating cost projections and long-term management are not unique to the Section 236 program. GAO's draft report (November 1977), "Need to Better Assess Financial Soundness Before Insuring Multifamily Residential Properties," identifies similar problems in a sample of Sections 221(d), 207 and 236 projects. The Department is cognizant of these continuing problems and is considering steps to minimize their negative effect on the insured programs.

The report notes the lower income level of participants in the Section 8 program. Currently available data on Section 8 participants is based primarily on the early activity in the Section 8 Existing program, and it is possible that as Section 8 New Construction projects are occupied, we will find that the program is reaching a higher income target. We believe that it would be premature to reduce the current flexibility of the Section 8 program by a mandatory set-aside which would reserve units for different income groups within the eligible population. While we are considering a number of different strategies to enhance the delivery of housing resources to different income groups, this particular revision, without increases in appropriations for housing assistance, would only result in the loss of assistance by one income group - with even less resources - to another.

Comments on Major Recommendations

1. GAO recommends (pages 24-25) that greater support be given to the housing needs of moderate income households either by reviving the Section 236 program or by placing a requirement in the Section 8 law that some percentage of housing assistance under that program be reserved for moderate income households.

As the previous section of this response suggests, the Department would not support a reactivation of the Section 236 program without major design changes to provide an adequate subsidy mechanism. Although initially intended as a moderate income program, Section 236 was in actuality a lower income program with a subsidy designed for moderate income households. Although this deficiency did not limit the productivity of the program, this flaw has damaged the soundness of the program.

The one percent interest rate enabled a small amount of rental income net of operating expenses to support a large mortgage. However, because developers underestimated operating expenses in some cases, against HUD policy, some of the mortgages may have been artificially inflated. Also, because developers were permitted to assume that all occupants would have income at the limit, most projects had high mortgages resting on unreasonably high estimates of gross income.

The design of the subsidy mechanism made the financial soundness of Section 236 projects sensitive to changes in operating expenses and to the income level of the tenants. In Section 236, tenants pay at least the basic rent (operating costs plus amortization of mortgage at one percent) or, if greater, 25 percent of income, up to the fair market rent (operating costs plus amortization at FHA interest rate plus insurance premium). The sharp rise in operating costs in the mid-1970's, which was largely attributable to the higher cost of oil, pushed the basic rent upward. For the large majority of tenants, who were paying basic rent, every dollar increase in basic rent resulted in a dollar increase in their rental payments. As a result, the general rise in operating costs put financial pressure on many Section 236 tenants and weakened the financial soundness of projects.

This problem could be alleviated by a deeper subsidy or the provision of operating subsidies. GAO appears to recognize the importance of operating subsidies to the financial soundness of the Section 236 program but does not explicitly endorse operating subsidies either in its recommendations to revive Section 236 or elsewhere in the report. We would note that the Congress has directed, in the Housing and Community Development Act of 1977, that a tax and utility subsidy be provided for Section 236 projects in order to provide for a reduction in basic rents.

The second GAO option -- placing a requirement in the Section 8 legislation that a fixed percentage of Section 8 funds be used to subsidize moderate income households -- is inappropriate. To the extent that moderate income households need housing assistance, it appears to us to be more equitable to provide assistance to this group through an increase in funds going to housing assistance programs without reducing assistance to more needy groups rather than by holding funds going to housing assistance payments constant and reducing the level of assistance to more needy groups.

2. GAO recommends (page 27) that the Department develop estimates of comparative costs -- both direct and indirect -- of various housing assistance programs.

HUD has been actively engaged in making cost-comparisons of the type GAO recommends for many years, and, as GAO notes, HUD has recently been refining the procedures used for these comparisons. We will continue to seek improvement in the methodology and data used in these studies. However, we believe it is important to realize that the comparative cost technique which GAO recommends is only one of many important criteria for analyzing housing programs. Other important criteria include: the target group served; the level of subsidy provided; the impact on the housing and non-housing consumption of participants; the impact on housing prices and the housing stock; and, the extent to which the programs promote fair housing. These other measures cannot be readily combined with the comparative cost technique to produce one overall measure of program success, but they are important concerns in their own right.

Another limitation is that the results of this form of analysis are frequently very sensitive to what indirect costs are included and what assumptions are made. For example, it is frequently assumed that the same unit is constructed under all the programs being compared. This presents no problem if the analysis is designed to compare the program on cost-effectiveness (value per dollar of Federal cost) but would be misleading if the analysis were designed to compare the programs on total costs to the Federal Government. In the latter case, differences in the quality of the units provided could be an important factor in differentiating the costs of the program. Comparisons of programs which utilize the existing stock of housing with new construction programs are particularly sensitive to this assumption.

The GAO has made a key assumption on page 9-7, i.e., that construction can take place with the same level of efficiency under all programs. There is good evidence that this assumption is not correct. Earlier studies indicated that Section 235 was less expensive than conventional structures but that Section 236 was more expensive. A second example of a key assumption which could affect the results is the assumption which GAO makes, and HUD has made in the past, that no alternative tax shelters would be available for investors in subsidized housing.

The supposed superiority of public housing may be an example of the failure to tally all of the indirect costs. New financing in the tax exempt market raises costs for all borrowers in this market. Therefore, the lower cost of public housing may be offset by the reduced efficiency of Federal tax subsidies for municipal borrowing.

6

3. GAO recommends (pages 29-30) that the Department undertake steps to study multifamily mortgage risk, provide Congress with an analysis of past FHA foreclosure problems, develop the capacity to evaluate program changes in terms of likely insurance losses and consider suspending commitments in all mortgage insurance programs for non-profit sponsors and cooperative and rehabilitation projects because of the higher default experience of these sponsors and projects.

Our experience with subsidized housing clearly indicates a need to understand better the factors which make some projects more risky than others. We have recently completed an analysis of the financial status and problems of HUD's inventory of insured subsidized projects. This effort revealed that many projects have serious problems but that some of these projects could be saved from assignment or foreclosure by a more flexible subsidy vehicle, one which can adjust to rapid increases in operating costs, and better HUD oversight and project management. We are currently considering a number of steps to improve HUD's oversight and project management. We also plan a thorough study of multifamily default risk in this coming year. We will be glad to apply these results to analyze past foreclosure experience and to try to make these findings more understandable to Congressional decision-makers. We will also utilize the results of this study to evaluate future FHA insurance programs and changes to existing programs in terms of likely insurance losses. However, we do not believe that it would be appropriate to suspend issuing new commitments for non-profit sponsors, cooperative, or rehabilitation projects while these steps are being taken. This is particularly true in light of the Department's overall experience with cooperative housing, which has demonstrated a very low default rate.

Other Comments On the Report

1. In several respects we believe the proposed GAO Report is incorrect in its interpretation of Section 236 history and experience. One such area is the question of what income group the program was designed to serve. The proposed report argues that Section 236 was intended to serve moderate income households. This thesis is not correct. As originally proposed, Section 236 was intended for moderate income households. However, the Congress rejected this as a sole orientation and specifically altered the eligibility formula to focus the

program on lower income households. The original Section 236 proposal submitted in 1968 by President Johnson to Congress was designed to achieve a high volume of production by aiming at moderate income households. In response to a query as to why lower income limits were not used, Secretary Weaver answered:

> By having the more liberal upper limits, you have the possibility of getting a greater volume quicker and also of providing relatively small subsidies to those who need less help but still need some help in order to obtain decent housing.

But Congress did not accept this proposal. The Senate cut the income limits to 70 percent of local median income, for 80 percent of the funds. The remaining 20 percent of the funds could be provided for families that exceeded these limits. It simultaneously allowed a $300 deduction for each minor child. Republican Senators were critical, with Senators Bennett, Tower, and Hickenlooper stating: "To allow that 46 percent, or, almost half, of our Nation's families must be supported by their government, is certainly not acceptable in our opinion."

The House was not satisfied by the rollback of the regular income limits to 70 percent of median income, and cut back the maximum permissible income even farther -- to a figure representing 130 percent of the income that would make one eligible for public housing admission. A Senate-House Conference Committee finally settled on a 135 percent figure.

The mixture of a lower income limit while retaining the original subsidy level was seen as a problem by knowledgeable Congressmen and the prestigious President's Committee on Urban Housing (The Kaise Committee). Representative Reuss felt that the program as designed would serve "paupers plus 30 percent." Representative Barrett, the Chairman of the House of Representatives' Subcommittee on Housing, felt that the amendments would "cripple the program." In its report, A Decent Home, the Kaiser Committee combined both complaints:

Congress has often unwittingly undermined the feasibility of these programs by imposing income limits for eligibility which are too low given the maximum subsidy provided. If only a small subsidy is provided, but eligibility is restricted to poor families, the program will not work and private sponsors will refuse to use it. The Congressional motivation for imposing low limits for eligibility is apparently to make sure that the most needy families receive priority. This is indeed a worthy goal. But lowering eligibility limits without at the same time increasing the depth of the subsidy, in effect, squeezes the life out of the program by narrowing the effective target population. It is possible, for example, that Congress has seriously damaged the 235 Homeownership program and 236 Rental program by imposing income limits too low for the subsidy available.

2. In many respects, the proposed GAO Report will be a significant contribution to the study of subsidized housing programs. Because it will become a document which will be frequently cited, it is important to highlight any differences in the approach to analyzing subsidized housing programs which we perceive.

a. In assessing the performance of the Section 236 program reference is made frequently to the ratio of subsidized units to target population. It is argued that the income eligible population is not the correct target population. This is difficult to accept. The Congress established income and family status as the only tests of admission. Unlike public housing, no special preference was given to families displaced in the process of urban renewal or with a veteran. The exclusion of homeowners from the target population is particularly arbitrary.

Even if a more limited definition of the target population were acceptable, there would still be a problem with the analysis because GAO made adjustments only to the denominator of the ratio and not the numerator. In other words, Section 236 can be said to serve the moderate income

9

renter population which is inadequately housed only to the extent to which it draws its actual tenants from this population. Failure to make similar adjustments in the numerator results in the table on page 5-19 which clearly seems to imply that there is no housing problem among inadequately housed lower-income Blacks and Spanish-Americans.

b. Chapter 6 discusses the question of substitution between subsidized production and unsubsidized production. We would note that no study has documented any substitution effect in the production of multifamily housing. The study cited on page 6-1, which concluded that for every 100 units produced under direct government subsidies 14 units were actually added to the housing stock which would not have been added in the absence of the subsidies, dealt with single-family programs.

c. In discussing the default analysis informally with GAO staff it has come to our attention that the term "cumulative failure rate" is used inconsistently in the text. The discussion and analysis in Chapter 8 are well done. I have noted above our concern about limiting the analysis of the Section 236 default experience to the 1968-1973 period. We admit the usefulness of comparing program default experience across the same periods but would point out that this leaves us substantially short of the information needed for long-run projections. HUD was criticized for combining information on different programs from different periods to project Section 236 default rates for use in cost-benefit analysis. Yet GAO is forced to use even more ad hoc procedures on page 9-26.

d. The analysis in Chapter 4 would probably benefit from reemphasizing comparisons of the total populations served by the various programs in favor of emphasizing comparisons across the non-elderly and elderly populations. Differences in the extent to which various programs serve these markedly different groups could make comparison of the programs on the basis of average characteristics of the total population meaningless. The frequency distributions approach should be used more frequently in this Chapter and Chapter 5 because means and medians can be misleading. The text seems to imply that there is a difference between the tables on page 5-18 and the top table on page 5-19. Mathematically the ratio of percentages differs from the ratio of units only by a constant (the number of units in the program/number in target population). Therefore, both tables should lead to the same conclusions regarding the extent to which Section 236 serves Blacks and Spanish-Americans.

I hope you will find these comments useful. We appreciate the opportunity to comment on the proposed report.

Sincerely,

Donna E. Shalala

SECTION 236 RENTAL HOUSING-- AN EVALUATION WITH LESSONS FOR THE FUTURE (REPORT SUMMARY)

The section 236 1/ rental assistance program provided new and rehabilitated rental housing to low and moderate income tenants. It couples Federal Housing Administration (FHA) mortgage insurance with a direct mortgage interest subsidy, and the usual tax incentives for residential development as well as some special tax incentives for low and moderate income housing. This combination of subsidies and a 40-year mortgage term resulted in much lower rents than would have been possible in conventionally financed projects.

This is the foremost example of Government assistance for privately developed rental housing. This program, along with other major housing initiatives, was created in 1968 to boost the Nation's existing housing stock which was still considered inadequate in spite of 30 years of Government support. It was to provide new housing directly to lower income households. The Congress concluded that the private market could not provide needed additional housing without increased Government encouragement and assistance. Section 236 was to tap the resources and talents of private lenders, entrepreneurs, and philanthropic organizations by allowing private developers to operate low and moderate income housing in addition to building it.

This approach had been attempted earlier under section 221(d)(3) which provided either private market rate loans or 3-percent direct Federal loans. But funding was insufficient to provide significant production since with direct loans, the total cost of housing was budgeted in the year a project was started. Another drawback was that the section 221 interest subsidy was insufficient to reach tenants who were just above public housing eligibility yet still unable to afford section 221 rents.

By using private financing, with the Government making yearly contributions to the debt service, the impact on the Federal budget was less severe. The deeper section 236 subsidy, which paid all but 1 percent of the mortgage interest, lowered rents and made the program more attractive. Participation by private developers and nonprofit organizations on a large scale also increased potential yearly production

---

1/Section 236 (12 U.S.C. 1715z-1) was added to the National Housing Act by the Housing and Urban Development Act of 1968.

of low and moderate income units. Public housing production was limited by the number and talents of local housing authorities. Finally, the program was to concentrate its benefits on households which were earning too much to qualify for low rent public housing, yet too little to afford adequate housing without assistance.

In view of these objectives, section 236 achieved a great deal. It will ultimately result in constructing or rehabilitating more than half a million privately financed and privately developed rental units. The units primarily serve moderate income households. No other program has adequately served this group, and no current program promises to do so. Nevertheless, in January 1973, section 236 (and other major housing subsidy programs) was suspended and never reactivated. Some reasons cited were that these programs were inequitable, too costly, unsuccessful in concentrating benefits on the poor, difficult to administer, and ineffective in meeting the total housing need. Even with this moratorium, significant numbers of units have been produced under section 236 under earlier commitments. However, these commitments have largely been exhausted, and section 236 construction is nearly complete.

REASONS FOR THIS EVALUATION

The work for this report (PAD-78-13) was undertaken at the request of the Chairman of the Senate Appropriations Subcommittee on HUD and Independent Agencies. We were asked to undertake a broad based study of all aspects of the section 236 program. Our objectives were to put the section 236 program into perspective with other Federal programs and provide an objective assessment of its performance. The report examines the accomplishments and shortcomings of section 236 in order to explain what the program did, why it worked, and why it experienced problems. In addition, we felt we could provide some general insights into various methods for providing rental assistance and illustrate some valuable lessons which would be applicable to future housing policy.

The approach

The resulting research was performed primarily using studies and basic data which were readily available from HUD, other Government agencies, and private researchers. Much can be done using existing information to evaluate a program.

Since comparisons are essential to rational evaluation, they are essential in putting section 236 in perspective. The program is compared to national statistics for rental housing and renter households and to a variety of Federal programs. Program comparisons are made most frequently to the low rent public housing program, which is financed using Federal guarantees for tax free bonds, serves very low income households, and is administered by local housing authorities. Other programs also mentioned frequently include the section 207 (12 U.S.C. 1713) FHA mortgage insurance program for unsubsidized multifamily housing, which serves middle and upper income households and is produced by profit-motivated developers, and the section 8 (12 U.S.C. 1437f) leasing program, which emphasizes Government leasing of privately owned existing or newly constructed housing, and was designed as a replacement for both section 236 and public housing. Section 8 can be financed in many ways and has a flexible subsidy formula which theoretically can serve households which have a wide range of incomes.

WHO LIVES IN SECTION 236 HOUSING?

Households receiving assistance from the section 236 rental assistance program are strikingly different from those being helped by other multifamily subsidy programs. These households have higher incomes than public housing tenants. They have fewer members and tend to be younger. In addition, household members are more likely to earn the major share of their incomes instead of receiving welfare, retirement pensions, or other assistance.

	Median income	Percentage of elderly	Average family size		Percentage employed
			Nonelderly	Elderly	
Section 236 tenants	$5,785	19%	2.8	1.4	68%
Public housing tenants	3,531	42	4.2	1.5	26

Although these households have higher incomes, they generally cannot afford market rents and earn too much to qualify for public housing. Although they would be eligible for the section 8 leasing program, most existing units under that program are going to much poorer households which are similar to those served by public housing. Little construction activity has taken place under section 8, and roughly 70 percent of that construction is planned for the elderly.

Section 236 was intended to primarily serve moderate income tenants, and it does. The tenants are much poorer than the average U.S. family but earn more than public housing and section 8 tenants.

	U.S.	Section 236	Public housing	Section 8 existing
Median household income	$11,800	$5,785	$3,531	$4,000

The program also serves lower income tenants. This happened originally when the program was combined with rent supplement payments. However, the program also serves a larger percentage of poor tenants each year because of the subsidy mechanism and general inflation.

Using HUD data on tenants accepted for occupancy and Department of Commerce figures on poverty level, we estimated that in 1972, when the program was just getting started and average tenant income was $5,250, only 9 percent of all recipient households were at or below the poverty level. In 1976, the average tenant income had increased to about $5,800 and about 24 percent of all tenants were below the poverty threshold.

FHA CAN REACH INCREASINGLY LOWER INCOME HOUSEHOLDS AS TIME PASSES

This trend can be expected to continue. Supply oriented subsidies, such as section 236, which are aimed at increasing the number of units available, can serve relatively poorer tenants each year without significant increases in the subsidy, since rents, and hence the subsidy, are tied closely to the original cost of the project. Rents are, therefore, under control. Such results cannot be expected with a demand-oriented subsidy such as a housing allowance or existing leasing under section 8 which increases the recipient's ability to purchase housing. Such subsidies allow subsidized rents to respond to those in the market which are in turn a function of demand as well as cost. Some belief exists that demand-oriented subsidies contribute to inflated rents, but supporting empirical data is limited. Based on work now in process, we are unconvinced that the Experimental Housing Allowance Program, for example, will yield a reliable answer to this question. Section 236 really affected both supply and demand since it lowered rents to create effective demand and produced housing to respond concurrently to that demand.

QUALITY HOUSING AT REDUCED RENTS

The program provides good quality multifamily housing which is generally considered comparable (although with fewer amenities) to unsubsidized private housing which was built at the same time for more affluent tenants. However, the average monthly rent in section 236 housing was only $144 per month in 1976. (Rents for tenants in public housing and the new section 8 existing leasing program average less than $70 per month.) Nevertheless, section 236 households still pay a large percentage of their income in rent. In recent years most (64 to 68 percent) section 236 households paid in excess of 25 percent of their gross incomes for rent, according to HUD figures. Estimates of the actual rent reduction, which section 236 affords program beneficiaries, vary, but it is generally considered to average over $80 a month and is probably much higher when indirect effects such as longer mortgage term, limited profits, and tax expenditures are considered.

SERVICE TO THE ELIGIBLE POPULATION

The section 236 program and other housing programs probably serve a much larger share of low and moderate income households which have significant housing needs than is generally assumed. Past estimates of this housing program's impact have frequently shown that only a small percentage of intended recipients are served. One can reach this conclusion by examining a single program rather than all past and present programs and by defining eligibility based solely on income. The impact of all housing programs combined is much greater than a single program, and most housing programs are primarily intended to reach households with identifiable housing needs rather than financial needs. Many households which appear eligible for section 236 based on income, as well as public housing or other programs, actually own homes or already have adequate housing at affordable rents. For example, in "Housing in the Seventies," using income eligibility alone, HUD estimated the coverage of section 236 at a fraction of 1 percent. Our calculations indicate much higher impact.

During 1975, section 236 served about 250,000 households in the $5,000-$10,000 a year income group. Public housing and the rent supplement program provided housing to another 280,000 families in this group. Based on figures taken from the Annual Housing Survey, we estimated that fewer than 2.0 million households in this income group were in physical or financial housing need which had not been served by these programs. As a result, more than 20 percent of those in need were probably served by these programs. Other Federal subsidy programs and older FHA unsubsidized programs are probably also providing significant help to this group.

EXCEPTIONAL INVESTMENT INCENTIVES

Section 236 spurred FHA multifamily production by providing a unique set of investment incentives, subsidies, and mortgage market supports. These were made credible with substantial program funding and created a demand to which builders, lenders, and investors were encouraged to respond. The interest subsidy lowered the monthly debt service to principal plus interest at 1 percent per annum, making rents affordable. Small downpayments allowed builders and sponsors to begin projects with little cash in contrast to conventionally financed projects. FHA mortgage insurance made lending on section 236 projects virtually risk free. Government mortgage purchase guarantees from the Government National Mortgage Association which are probably necessary to the success of FHA financing, assured lenders that they could sell mortgages without discount, providing liquidity. Finally, the low downpayment and resulting high leverage combined with the high yearly interest expense due to 40-year financing allowed exceptional tax shelter for the personal incomes of passive investors.

PRODUCTION WAS SIGNIFICANT

Critics have argued that direct subsidy programs (assisted housing) account for only a small percentage of new housing construction and that such production is undertaken at the expense of private efforts. They conclude that the country must rely on private or unsubsidized production for most new housing. This assertion is true in that "assisted" production has never exceeded 20 percent of total production. However, several important facts have been overlooked. First, virtually all new construction is subsidized somewhat by the tax laws. These indirect tax subsidies for "private" housing are much larger than those for direct subsidies and benefit primarily middle and upper income households. Second, housing producers cannot supply housing to the poor without some additional assistance since market rents for adequate housing are beyond the poor's reach. Also, no clear consensus exists on how much subsidized (assisted) housing production increases total housing construction activity. Some researchers have concluded that it largely replaces private construction. Others feel that the increases are substantial. It is likely, however, that the truth is somewhere in between, with the relative split depending upon the economy, fund availability, and the health and capacity of the construction industry.

It is clear, however, that section 236 and other direct subsidies distribute housing to a group which could not successfully compete in the marketplace and that in recent years, these subsidy programs have been producing most newly constructed moderately priced rentals, even though the total number of such units has been shrinking. These points are supported by the following information:

--From early 1970 to late 1974, this program produced nearly a quarter of a million units which rented for between $100 and $150 per month. This was more than half of the 400,000 new rentals constructed during the period which had rents in this range, as reported in the Annual Housing Survey for 1974.

--Section 236, public housing, and rent supplements produced approximately 620,000 new units during the same period, which rented for less than $150 per month. This was 82 percent of the total U.S. production of low and moderate priced rentals during the period. State, local, and other small scale subsidy programs probably accounted for much of the remainder.

--During the same period the stock of low and moderate priced rentals (those with rents below $150 per month) shrank by nearly 3.8 million units while the number of renter households who could not afford higher rents, based on 25 percent of their incomes, decreased by only 1.5 million.

Whether subsidy programs actually increase U.S. housing production or merely replace private construction, low and moderate income tenants would not receive new housing without these subsidies. In addition, the stock of units available to these households has been shrinking.

THE SUBSIDY COSTS OF SECTION 236

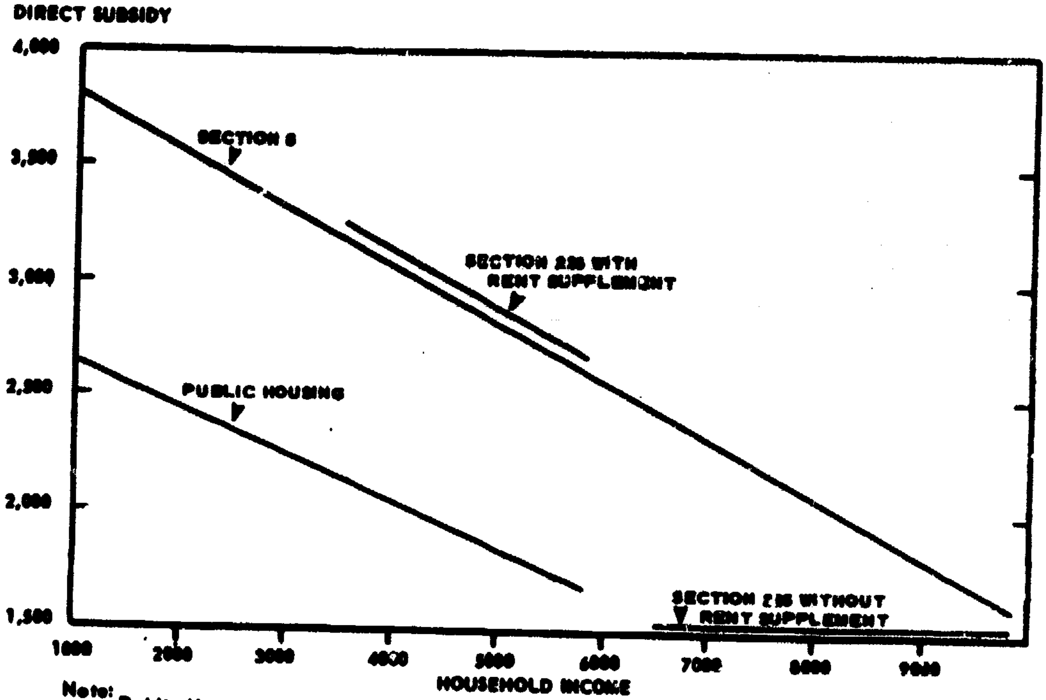
New construction under the section 236 program resulted in major subsidy costs to the Federal Government which were incurred in a variety of ways, including sizable tax expenditures. The exact subsidy amount varies to a great extent with the tenant's income, the cost of the housing unit, and the interest rate on the mortgage. These subsidies would likely be the same for new FHA-insured construction under section 8 or any other FHA-insured subsidy program except that many tenants would pay lower rents under section 8 than they did under section 236. (See ch. 10.)

Direct subsidy

For lower income tenants the yearly section 236 direct subsidy is generally higher than it would be under public housing and about the same as it would be for section 8. For a tenant at the higher end of the moderate income range, who would not ordinarily qualify for public housing, the direct subsidy under section 236 would generally have been less than anticipated under section 8. This occurs because of an upper limit on the section 236 subsidy. Tenants must pay at least the operating expenses plus principal and interest on the mortgage at 1 percent, unless they qualify for the additional rent supplement subsidy. This often caused section 236 tenants to pay in excess of 30 or even 40 percent of their incomes in rent, while section 8 tenants can pay no more than 25 percent of their income, after adjustments, for family size.

Direct subsidies, as a function of tenant income under all three of these programs, are shown in the following graph for a typical newly constructed apartment. The differences between sections 8 and 236 reflect the different tenant rents resulting from these programs' rules.

NEW CONSTRUCTION
DIRECT SUBSIDY (DOLLARS)
TWO BEDROOM APARTMENT, FOUR-PERSON HOUSEHOLD
TOTAL DEVELOPMENT COST=$27,125



Note: Public Housing eligibility would probably lapse somewhere between $5,000 and $6,000. Section 236 rent supplement payments would be dropped at about the point that public housing eligibility lapses.

Yearly Direct Subsidy for a Family of Four (note a)

Gross annual tenant income	Section 236 Limited dividend	Section 236 Non-profit	Section 8-limited dividend	Conventional public housing
$4,250	b/$3,041	b/$3,294	$2,988	$1,988
9,000	c/1,531	c/1,701	1,800	(not eligible)

a/Based on a unit development cost of $27,125.

b/With rent supplement.

c/Without rent supplement.

Indirect subsidies

The indirect costs for section 236 have generally been calculated as much lower than those of public housing, and our calculations show the same result. However, we found the difference was less than usually reported by HUD and others. In the past HUD has generally underestimated the cost of related tax expenditures, ignored or understated the cost of mortgage failures and Government National Mortgage Association Tandem subsidies, and used a very high estimate of public housing related tax expenditures.

Using assumptions which we feel still understates the cost of section 236 subsidies yet overestimates the costs of public housing subsidies, we calculated the long-term discounted costs of public housing as somewhat less than the other alternatives. If less conservative estimates were used, public housing could be shown as much less expensive than the FHA alternatives.

New Construction

Discounted Annual Subsidy Cost (20-Year Average)

for a Family of Four With $4,250 Annual Income

	Section 236 with rent supplement		Section 8- Profit motivated	Public housing
	Profit motivated	Non-profit		
Direct subsidy	$1,848	$2,002	$1,816	$1,208
Federal tax foregone	272	-	272	459
Tax revenue on sale (after 20 years)	-49	-	-49	-
Insurance losses	-15	323	-15	-
Tandem plan subsidy	105	153	105	-
Local tax foregone	-	-	-	318
HUD administration	20	20	20	20
Total	$2,181	$2,503	$2,149	$2,068

However, one cannot automatically conclude that the FHA alternatives are less cost-effective. Section 236 caused the production of a large number of units very rapidly. The program attracted many private investors who provided capital and entrepreneurial skills to a very new endeavor (that is, providing housing through the private market to low and moderate income households with considerable

Government assistance). This had never been accomplished on any credible scale under the older programs, and section 8 does not appear to be providing any new construction volume, except perhaps for elderly housing.

We also estimated the costs of rehabilitation under section 236. Assuming a rather high rehabilitation cost (which was typical under subsidized rehabilitation), the direct subsidy costs were lower than for new construction,

Average Yearly Cost (First 5 Years)
Two-Bedroom Unit, Family Income of $4,250

	New construction	Rehabilitation
Development cost	$27,125	$23,463
Direct subsidy	3,040	2,525
Federal taxes foregone	670	1,532
Total subsidy	$ 3,710	$ 4,057

but the long-term cost of rehabilitation, including sizable tax expenditures and other indirect subsidies, was substantially higher.

Discounted Annual Subsidy Cost
(Family of Four, $4,250 Annual Income)
(20-Year Average) (note a)

	Section 236 new construction	Section 236 rehabilitation
Total development cost (TDC)	$27,125	$23,463
Direct subsidy	1,848	1,535
Federal taxes foregone	272	474
Revenue on sale after 20 years	-49	-58
Insurance losses	-15	252
Tandem plan costs	105	123
HUD administration	20	20
Total subsidy	$ 2,181	$ 2,346

a/Both alternatives are with rent supplements and limited dividend sponsorship.

This conclusion would also apply to rehabilitation under other FHA programs which use profit-motivated developers since the factors contributing most to high cost under rehabilitation were exceptional tax savings for investors in the first 5 years and a much higher mortgage failure rate. These factors would probably affect any FHA rehabilitation program. However, certain indirect costs, which were not considered, might be saved under the rehabilitation approach since services such as streets and sewers probably already existed for rehabilitated units. Rehabilitation would probably be much cheaper when developed by nonprofit sponsors (since no tax expenditures are involved) if the exceptional mortgage failure problems experienced by both nonprofit and rehabilitated projects could be alleviated. Rehabilitation may encompass other goals such as rejuvenating or preserving residential neighborhoods which could outweigh the cost consideration in some circumstances.

Leasing existing units was compared to new construction in various housing markets. In the short run section 8 leasing resulted in savings in all these markets, but many factors could cause existing rents to increase more rapidly than new construction. By considering only a few of these factors, such as moderate appreciation in property values and periodic refinancing, we showed that in a tight housing market with relatively high existing rents, the long-term costs of leasing could easily outstrip new construction subsidy costs. More importantly, if all costs and factors which might increase leasing costs over time were considered, including inflation induced by high demand, leasing might in general prove more expensive than new construction or the magnitude of the hoped for savings could be much lower.

<u>Cost compared to private housing</u>

In preparing this paper we performed a literature search and analysis of previous attempts to show that newly constructed private housing was in some sense cheaper than new publicly assisted housing.

None of the research adequately dealt with the myriad problems involved in such comparisons. Therefore, we must conclude that little is really known about this question. Conceptual arguments and explanations exist as to why publicly assisted production should be more expensive, such as higher wage rates due to Federal law and higher financing charges resulting from construction delays. However, these can be balanced by arguments that publicly financed construction may lower rents without increasing costs. For example, longer financing terms are available for assisted housing. These longer terms greatly reduce the rents necessary to carry the housing. In addition, housing which does not have to be competitive in the private market can be built with fewer amenities and smaller floor plans. One reason often cited to explain why assisted housing may be more expensive to construct is that stricter building requirements under FHA or Public Housing drive up costs. These requirements are really minimal and cannot be considered as increasing cost. Any lower quality might result in inferior construction, and competent private builders could be expected to meet these standards. When these standards were not met, higher maintenance and operating expenses would likely result.

FHA MORTGAGE FAILURES

Defaults and mortgage failures under FHA multifamily insurance programs were given by HUD as major reasons for the suspension of section 236. However, we found that the failure problem was probably not as pervasive as portrayed. This conflict may be partially explained by the lack of clear and concise information available on mortgage failures and a lack of perspective in most FHA failure comparisons. This report treats these shortcomings in some detail and concludes:

--Past comparisons by HUD have been misleading.

--No accepted criteria presently exists for judging failure experience other than whether insurance losses exceed premium income which is not valid for section 236 because this program was expected to incur somewhat greater losses than unsubsidized programs. (The Congress actually made provision for funding such losses.)

--Some general criteria are needed for projecting risk and analyzing failure experience in FHA programs.

Mortgage failure analysis

We also presented our own discussions and comparisons of section 236 failure experience. These explained the degree of risk involved in this program and examined the section 236 experience as objectively as possible. Most section 236 financial failures occurred in nonprofit and cooperatively sponsored projects rather than profit-motivated ones. Roughly 58 percent of all failures were in nonprofit and cooperatively sponsored projects although they comprised only about 30 percent of total insurance.

Nonprofit and Cooperative Sponsors Comprise a Disproportionate Share of Failures June 30, 1976

Type of sponsor	Percent of sponsored projects	Percent of project failures
Nonprofit	23	47
Cooperative	6	11
Limited dividend	71	42
Total	100	100

These failures very likely resulted from lack of experience and limited financial resources in the nonprofit or cooperatively sponsored projects which contributed to management problems and made it difficult to meet unexpected expenses during construction or operation. Rehabilitation projects have also had high failure rates. Avoiding these and other risky projects would have produced a much lower failure rate for section 236. But even including these projects, the failure rate is neither as high nor as costly as often implied.

Assisted by an actuarial consultant, we analyzed the failure experience of the section 236 program between 1968 and 1973, just prior to the moratorium on subsidized housing. We found that the failure rate for section 236 projects started during the period was equal to that of another unsubsidized FHA multifamily program for middle and upper income households, section 207. Section 207 was not suspended. Both these programs had failure rates which were substantially better than other programs operating at the same time.

Section 236's Failure Rate Was Equal to or Better Than Other FHA Programs During the 1968 to 1973 Period

Program	Percent of cumulatively insured units which failed
Section 236	8.8
Section 207	8.8
Section 221 BMIR	14.9
Section 221 MIR	15.3

Section 207's failure experience is usually considered the best among all multifamily programs. The [illegible] section

207 is thought to be better may be that it tends to lose less money when it fails and units are subsequently sold. The following table shows that for projects started between 1968 and 1973, section 207 lost less per unit produced than did all section 236 projects. However, section 207, which is developed by profit-motivated sponsors, has lost much more when compared to profit-motivated (limited dividend) section 236 projects. As mentioned earlier the high failure rate for section 236 projects is attributed to nonprofit sponsors. The failure rate for limited dividend projects is much lower.

	Failure rate	Units failure costs	Cost per unit produced
Section 207	8.8%	$5,443	$ 478
Section 236			
All projects	8.8	9,174	807
Limited dividend	3.3	7,922	261
Nonprofits	14.6	9,671	1,411

A separate cost analysis was performed by us based on the pessimistic assumption that 2 out of 5 nonprofit units will fail and 1 out of 10 limited dividend projects will fail during a 20-year period. Calculations showed that when losses were subtracted from insurance premiums, nonprofit projects would cause substantial losses to the insurance fund for each unit produced while the fund would probably break even on limited dividend projects. (See p. 116.)

Multifamily FHA insurance failures appear high when compared to private financing, but FHA insures the entire mortgage when construction begins. Private mortgage insurers will not insure construction loans since construction is the riskiest period in the life of a residential project. Furthermore, private lenders require higher downpayments from developers. Even after construction is complete, private insurers underwrite only 20 percent of the mortgage amount. So the lender still stands to suffer a financial loss if the project fails. This is not the case with FHA-insured projects which may cause lenders to be less concerned about working out problems when they arise. Lenders on private projects also require sponsors and developers to have had some successful experience. FHA does not. This means that private insurers take little risk compared to FHA and, consequently, have fewer and less costly failures. FHA is not competing with private insurers. Rather it is encouraging construction which otherwise would not take place.

We analyzed and summarized the specific factors which explain multifamily mortgage failures. The most important and most credible of these factors are shown below:

--Many projects fail during construction or because of problems originating during construction. These problems are often aggravated when the sponsors having the difficulty are inexperienced or underfinanced. In addition, the Department of Housing and Urban Development's monitoring may have been inadequate since it emphasized planning versus followup and because HUD was probably improperly staffed for monitoring.

--Operating costs were underestimated during project planning, and rents were inadequate to cover them.

--Utility costs rose unexpectedly in recent years, and HUD was probably slow in granting necessary rent increases. As a result, projects lacking strong financial assets will very likely fail.

--Projects had insufficient slack built into the rents to allow for unexpected cost increases. Section 236 limited dividend sponsored projects must limit cash flow to about six-tenths of a percent while similar privately financed projects plan a yearly return of 3 to 4 percent of the project's value. Nonprofit projects have no profit margin whatsoever.

--Projects which failed were often located on poor sites which were either too close to undesirable industry or too distant from places of employment, schools, and other needed services.

--Projects in urban renewal areas and rehabilitated projects are more prone to fail.

--When a section 236 project defaults, lenders are not motivated to work out the problems with project sponsors because of the full guarantee against losses. Lenders can pass off troubled projects to HUD easily by a process known as "assignment" in which HUD pays 99 percent of the mortgage balance and assumes responsibility for the lender. Thus, many projects may have failed when they could have been saved by proper handling by the lender.

GAO RECOMMENDATIONS (JANUARY 10, 1978 REPORT)

Moderate income housing

Section 236 has been effective in providing housing for moderate income households during a period when the stock of moderately priced rentals has been shrinking rapidly. But section 236 construction is complete, and HUD has refused to make new commitments under the program. Current public policy provides housing assistance to many low income households through public housing, section 8, and other State and local programs. Middle and upper income households continue to benefit from sizable tax expenditures for mortgage interest deductions and tax incentives for rental housing. Congress has repeatedly affirmed its conviction that moderate income households should be served by enacting programs which could serve this group. Although section 8 is also theoretically capable of subsidizing moderate income households, the leases for existing housing units have thus far been for the very poor, and new construction under section 8 seems to be aimed at the elderly. Section 8 may never reach moderate income households since no control exists in the subsidy mechanism to assure their inclusion. We find no reasonable explanation for why one American income group should be excluded from housing assistance while others receive significant help.

Recommendation

The Secretary of Housing and Urban Development should design positive measures to assure that moderate income households receive some equitable share of future housing assistance. HUD should revive section 236 to provide moderate income housing until some workable alternatives are developed. This would also necessitate implementation of the section 236 operating subsidy provision.

Recommendations to the Congress

If the Congress wishes to assure that moderate income households receive a reasonable share of future housing assistance, we recommend that the Congress:

--Provide additional funding for section 236 to allow HUD to enter into new commitments under the program.

--Amend present housing law to require that some percentage of new housing assistance funds be used to subsidize households which the Secretary defines as having moderate income.

These measures would provide added flexibility to the Department's housing strategy.

Housing subsidy costs and housing strategies

Housing subsidy costs have often been unsatisfactorily analyzed with little consideration being given to indirect subsidies or long-term costs. Consequently, the real costs have often been misunderstood. In an earlier staff study 1/ on subsidized housing costs, which is the basis for the cost information in this report, GAO suggested that HUD be required by the Congress to use long-term cost estimates when comparing programs. HUD is now preparing a comprehensive comparison of its major programs, using methodology closer to that suggested by GAO in that staff study. In making such comparisons in the past, the costs of leasing existing units, such as under section 8, and providing housing allowances have been particularly elusive since the indirect costs of these alternatives are generally omitted, and are quite difficult to estimate for the long term.

These alternatives, nevertheless, continue to be stressed primarily because of short-term cost savings as compared to new construction. We question the amount of short-term savings achieved using leasing or allowances when indirect costs are considered and also whether long-term savings really exist when rent increases due to subsidy induced inflation and other uncontrollable factors are included.

If the projected long-term savings under leasing and allowances did not materialize and these policies were substituted for new construction, then the ultimate effect could be a decline in housing production at a time when the Nation's housing stock is insufficient without the hoped for savings. Thus, the method of comparing subsidy costs is crucial to future housing policy decisions.

Recommendation

The Secretary of Housing and Urban Development should assure that long-term costs of subsidizing extensive leasing of existing units or providing housing allowances are carefully analyzed and compared to long-term costs of subsidizing new construction.

Recommendation to the Congress

Until these questions of costs are resolved, the Congress should consider requiring that housing funds be expended to balance existing housing subsidies with new construction

---

1/ "A Comparative Analysis of Subsidized Housing Costs," General Accounting Office, July 28, 1976, PAD-76-44.

subsidies. This should minimize the risk of pursuing a strategy which would be detrimental to either the future supply or cost of housing.

FHA mortgage failures

The mortgage default and failure problem under section 236 was not as serious as it might seem. Some risk is necessary in any insurance program, and FHA was set up to take risks that private insurers would not. This is done to induce added production, and, in the case of section 236, it is production which would otherwise never have taken place. What has been missing is a perspective on what risks FHA should take and those which it should avoid. Profit-motivated section 236 sponsors appear to have an acceptable failure experience in terms of both numbers and cost of failures. Whereas nonprofits, cooperatives, and rehabilitations may be too expensive and troublesome to be justified. In the past FHA has taken virtually any risk which met certain tests while private lending institutions and insurers have taken very little risk. What FHA should do is undertake projects involving reasonable risks as judged by the expected production and financial losses and administrative burden. However, there has been serious difficulty in identifying these reasonable risks. Determining whether a program, or an insurance fund, is actuarially sound (will reserves cover expected losses) is not necessarily a reliable measure since FHA insurance premiums are set arbitrarily, and under subsidized programs these premiums are really paid by the Government. Simply comparing one insurance program to another is rarely enlightening since few FHA programs are really comparable because they have operated over different time periods with different subsidy and management arrangements. FHA cannot be compared to private mortgage insurance funds since these handle only the best insurance risks.

In this report, we compared section 236 with other FHA multifamily programs which were in operation at the same time and found that for insurance written during those 5 years section 236 was no worse and often better than other FHA programs. We then looked at subgroups of section 236 projects to conclude that new profit-motivated projects did much better than nonprofits, cooperatives, and rehabilitation projects. We also explain the differences between private insurance funds and FHA in terms of risks taken and note that the most troublesome FHA projects could have been expected to have high failure rates based on the risks involved in these projects and prior program experience. For example, nonprofit sponsors were often inexperienced and lacked financial resources, and nonprofits had established spotty records under earlier programs. In spite of HUD's experience with past multifamily programs, the Department plans to devote more than half of its 1978 construction commitments under section 8 to nonprofit sponsors and rehabilitation projects. Our work on mortgage failures helps to increase understanding of the problem, but additional and more focused information is needed. Until such information is developed, HUD needs to modify its policy for insuring subsidized projects.

Recommendations

The Secretary of Housing and Urban Development should:

--Establish criteria for judging the performance of multifamily insurance programs as well as procedures for screening out high risk projects. This may require a study of multifamily mortgage risk which links actual loss rates to factors which make certain projects inherently risky. Similar work has already been performed by HUD for single family insurance risk.

--Provide the Congress with an analysis of past FHA program failure experience which makes this history more understandable.

--Evaluate future FHA insurance programs or changes to existing programs in terms of likely insurance losses and present these when proposing program modifications or new alternatives such as the section 248 subsidy program for the working poor which is under consideration by HUD.

--Suspend commitments for nonprofit, cooperative, and rehabilitation projects until criteria are developed and procedures implemented for predicting and avoiding unacceptable risks.

AGENCY COMMENTS UNAVAILABLE

Although this report was furnished to the Secretary of Housing and Urban Development for comment, we were unable to obtain written comments in time for inclusion in this report.

(92026)