MANAGEMENT OF HUD'S SECTION 8 MULTIFAMILY HOUSING PORTFOLIO

HEARING

BEFORE THE

SUBCOMMITTEE ON HUMAN RESOURCES AND INTERGOVERNMENTAL RELATIONS

OF THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

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CONTENTS

MANAGEMENT OF HUD'S SECTION 8 MULTIFAMILY HOUSING PORTFOLIO

TUESDAY, JULY 30, 1996

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HUMAN RESOURCES AND
INTERGOVERNMENTAL RELATIONS,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 2247, Rayburn House Office Building, Hon. Christopher Shays (chairman of the subcommittee) presiding.

Present: Representatives Shays, Morella, and Davis.

Staff present: Lawrence J. Halloran, staff director and counsel; Robert Newman, professional staff member; Thomas M. Costa, clerk; Marty Morgan, full committee professional staff member; and Cheryl Phelps, minority professional staff member.

Mr. SHAYS. I will call this hearing to order and welcome those who will be testifying today and also our guests.

A tidal wave is coming, and we are not prepared.

It is not a question of whether, but when the rent subsidies on more than 700,000 units of low-income multifamily housing will be unsustainable under even the rosiest Federal budget scenario. As a result, the FHA will be forced to pay up to $18 billion on defaulted mortgages. The places that 1 million Americans call home will be left to decay or be torn down.

Without definitive administrative and legislative action, this process is inevitable.

Today, we look at HUD's plans to hold back the flood that threatens to swamp more than 8,500 multifamily properties.

According to the GAO, three longstanding problems are sinking the section 8 project-based multifamily housing subsidy program: high subsidy costs, high exposure to mortgage insurance loss, and the poor physical condition of many properties. These problems can be attributed to program design flaws that inflate subsidies above market rents and place all the risk of loss on HUD.

HUD bears all the risk because, as both mortgage insurer and subsidy provider, only HUD pays the price of default and only HUD subsidies keep the mortgage out of default. This dual, some say conflicting, role in project-based, low-income, multifamily housing finance traps the Federal Government into above-market subsidies and traps tenants in substandard apartments.

GAO also attributes the deteriorating condition of many buildings to weaknesses in HUD's oversight and management of its multifamily portfolio, permitting physical and financial problems to fester and grow.

To their credit, HUD Secretary Cisneros and his staff have twice offered initiatives to address the structural flaws in the section 8 project-based subsidy program.

The first called Mark to Market would have transformed all project-based assistance into tenant vouchers. To reflect the removal of above-market rent subsidies and to keep the buildings viable, the plan called for forgiving or marking down some or all of the outstanding federally insured mortgage debt.

But the proposal collapsed under the weight of questions about the validity of the admitted best guesses upon which HUD based Mark to Market, as well as questions about HUD's capacity to renegotiate so many mortgages and subsidy contracts. Nor were property owners or tenants persuaded their interests would be protected.

In an effort to address those concerns, HUD retooled the proposal calling the second effort Portfolio Re-engineering. The new plan focused on reducing above-market rent subsidies and would involve State and local governments in deciding whether, and to what extent, current project-based subsidies would be converted to tenant-based assistance. Portfolio re-engineering would also involve State housing finance agencies and qualified, private third parties in implementing the debt restructuring.

But by permitting FHA insurance on restructured mortgage loans, Portfolio Re-engineering fails to break the current system of dual, interlocking subsidies that insulate properties from true market forces.

The new plan's focus on reducing above-market rents abandons the more pressing, near-term problem of under-subsidized properties, leaving them prey to continued physical decay as both short- and long-term maintenance and capital needs go unmet.

Tenant groups, particularly the elderly and disabled for whom the rental market offers few real options, remain suspicious of losing the project-based program that helps ensure they will have some place to live.

In short, neither effort convinced the Congress, building owners, tenants, or State and local governments that it would work to improve low-income rental housing stock, protect vulnerable tenants, or save money.

This year, Congress and HUD only dipped their toes into the sea of troubles plaguing the FHA-insured, section 8 multifamily portfolio. Expiring subsidy contracts may only be renewed for 1 year. In fiscal year 1997 HUD appropriation contained $30 million to fund a pilot program to restructure the mortgages and subsidies on up to 15,000 of those units. Much depends on the outcome of that demonstration.

More than half the entire portfolio will be at risk over the next 3 years. Subsidy contracts on more than 230,000 units, or about 25 percent of the portfolio, expire in 1997. Contracts on up to 250,000 more units expire over the subsequent 2 years.

What is demonstrated by re-engineered financing on those 15,000, or fewer, units will have to tell us a great deal about what will work and what it will cost to save the remaining 685,000 apartments someone calls home.

We need to know much more than we do now about the restructured forms of mortgage debt, insurance, and subsidies that will bring beneficial market forces to bear on multifamily housing, and we need to know much more about HUD's capacity to structure and manage such an undertaking.

It is our hope this hearing, and others that will undoubtedly be needed, will help solve this looming housing crisis before the tidal wave of default engulfs a substantial portion of the low-income housing stock.

Time is running out. Unless the administration, Congress, State and local governments, building owners and tenants can agree on less tentative solutions that address the entire section 8 portfolio, the Federal Treasury and U.S. taxpayers will, over the next 7 to 10 years, take a $18 billion bath in the ensuing subsidy collapse and mass mortgage defaults.

On that somber note, we welcome our witnesses today and look forward to their testimony.

I would like to say, this is a family affair. This is going to be a solution that all of us are going to have to keep in mind, and there are no stones being thrown anywhere on this one.

With that, I would ask if Mrs. Morella has any statement?

Mrs. MORELLA. Thank you, Mr. Chairman.

I want to thank you for convening this hearing today on the HUD section 8 multifamily housing portfolio, not only because I believe it is an important subject, but earlier this year I received a number of letters from constituents who were concerned over their investment in section 8 housing. Almost all stated that they had made the investment in good faith to encourage the availability of housing for all Americans, but they were now fearful that the change in the conditions of the expiring contracts would contain a tax risk of cancellation of indebtedness income.

In response, I conveyed this concern to the chairman of the Banking and Financial Services Committee, Representative Jim Leach, and was pleased to learn from him that the question was receiving both committee and HUD consideration. Therefore, I am here today to learn about the alternative proposal being introduced by HUD, entitled "Portfolio Re-engineering," and to have the opportunity to assess the costs and potential problems which may ensue if no action is taken.

So I commend you, Mr. Chairman, for addressing this important issue.

HUD has made a significant contribution to housing in Montgomery County, MD, and I look forward to discussing the potential solutions with your distinguished panel of experts.

Thank you, Mr. Chairman.

Mr. SHAYS. Our ranking member, Mr. Towns, has a guest chaplain, so he will be a little late, but we do have a quorum of two, which is necessary to ask unanimous consent, and this will be pretty much pro forma unanimous consent.

I ask unanimous consent that all members of the subcommittee be permitted to place any opening statements in the record and that the record remain open for 3 days for that purpose.

Without objection, so ordered.

[The prepared statements of Hon. William F. Clinger, Jr., and Hon. Chaka Fattah follow:]

Opening Statement of William. F. Clinger

Chairman, Committee on Government Reform and Oversight

Subcommittee on Human Resources and Intergovernmental Relations

Hearing

Federally Insured, Federally Subsidized, Privately Owned:

A Housing Disaster in the Making

July 30, 1996

Thank you, Mr. Chairman. I am pleased that you have chosen to hold a hearing on this matter. It is an issue that needs to be looked into and I commend you.

There is, indeed, a crisis looming over the federally assisted, privately owned housing program. This hearing is to learn whether that crisis can be averted before the taxpayers are once again subjected to a high priced bail-out caused in part by the years of lukewarm supervision and constant first aid that has characterized HUD administration of the Section 8 program.

And, that's not the worst of it. About 700,000 units in apartment buildings will be affected over the next 7 years as the contracts which guarantee the Section 8 program continue to expire. That amounts to about 1 million residents.

HUD tells us that its preferred approach to crisis control is to restructure existing financing on the properties, and provide rehabilitation to units that require it. An ambitious cure that depends on the new program called "Portfolio Reengineering."

But, how much is it going to cost? How long will it take? Does HUD have the staff resources, and the technical expertise to make it work?

Today, Chairman Shays has convened this hearing not only to examine the problem, but to discover whether HUD has the necessary strengths to implement such a program. It is a serious, complicated and troubling matter that needs firm and diligent oversight if we are to avert a major financial calamity and continue to answer the housing needs of a great many low income American families.

Mr. Chairman. I commend you for holding this important hearing and I look forward to hearing these witnesses.

Thank you, Mr. Chairman.

STATEMENT OF CONGRESSMAN CHAKA FATTAH SUBMITTED FOR THE RECORD ON THE HEARING ENTITLED, "MANAGEMENT OF HUD'S SECTION-8 MULTI-FAMILY HOUSING PORTFOLIO." TUESDAY, JULY 31, 1996. COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT, SUBCOMMITTEE ON HUMAN RESOURCES AND INTERGOVERNMENTAL RELATIONS.

I WANT TO COMMEND THE DEPARTMENT FOR THE EXCELLENT JOB THEY HAVE DONE WITH THEIR "PORTFOLIO RE-ENGINEERING" PLAN. I DON'T KNOW WHEN I HAVE SEEN A BETTER JOB OF TAKING LEMONS AND MAKING LEMONADE!

I WANT TO INVITE MY COLLEAGUES ON THE OTHER SIDE OF THE ISLE TO JOIN WITH US ON THIS ONE, AND MAKE THIS A TRULY BI-PARTISAN EFFORT TO SAVE THE TAXPAYERS BILLIONS OF DOLLARS.

HUD HAS DONE EVERYTHING RIGHT ON THIS ONE. THEY HAVE BEEN PROACTIVE. THEY HAVE BEEN BRINGING THIS MATTER TO OUR ATTENTION FOR TWO YEARS NOW. IT'S LONG PAST TIME FOR US TO ACT. THIS IS A PROBLEM THAT WILL NOT GO AWAY, AND THE LONGER WE WAIT TO RESOLVE IT, THE MORE IT WILL COST.

HUD's PORTFOLIO RE-ENGINEERING PLAN PROTECTS THE INTERESTS OF ALL THE STAKEHOLDERS IN THIS ARENA. TENANTS ARE PROTECTED BECAUSE THEY ARE NOT FORCED TO MOVE, BUT THEY HAVE THE OPTION TO MOVE IF THEY CHOSE TO DO SO.

PROJECT OWNERS ARE PROTECTED BECAUSE THEY ARE NOT FORCED TO INTO DEFAULT, AND THEY ARE SHIELDED FROM UNEXPECTED TAX CONSEQUENCES.

TAXPAYERS ARE PROTECTED BECAUSE WHOLESALE DEFAULTS ARE PREEMPTED. HUD'S MARKET DRIVEN APPROACH EVEN CREATES THE POSSIBILITY THAT TAXPAYERS COULD TURN A PROFIT ON THE DEALS. THE BUSINESS PARTNERS THROUGH WHOM HUD PLANS TO CONDUCT THESE NEGOTIATIONS ARE SEASONED HOUSING MARKET SPECIALISTS WHO KNOW HOW TO CREATE AND TRANSFER VALUE. I AM DELIGHTED TO HAVE THEM ON OUR SIDE.

THE S&L DEBACLE COST THIS COUNTRY 150 BILLION DOLLARS. WHO KNOWS WHAT WE COULD HAVE DONE IF WE HAD HAD THIS KIND OF CREATIVE, PROACTIVE THINKING AT OUR DISPOSAL ON THAT ONE. THE UNDERLYING FINANCIAL TRANSACTIONS ARE COMPLEX, I REALIZE THAT. BUT THE INGREDIENTS FOR SUCCESS ARE THERE. WE NEED TO PUT ALL THE COMPONENTS OF THIS PLAN ON THE TABLE, MAKE SURE WE UNDERSTAND IT, AND THEN GO FORWARD CO-OPERATIVELY TO IMPLEMENT IT FOR THE BENEFIT OF ALL CONCERNED.

Mr. SHAYS. I ask unanimous consent that our witnesses be permitted to include their written statements in the record.

Without objection, so ordered. When Mr. Towns comes, if he has a statement, we can let him interrupt the witnesses or let him make a comment afterwards.

The GAO is our first group, Judy England-Joseph accompanied by Rick Hale and Christine Fishkin. Do I understand that we have a video to start with?

Ms. ENGLAND-JOSEPH. Yes, sir.

Mr. SHAYS. We will swear you in. Do we get to swear the videotape? How does that work?

[Witnesses sworn.]

Mr. SHAYS. For the record, all the witnesses have responded in the affirmative.

Ms. Fishkin, you looked confused when you had to raise your right hand. You will not have to give testimony, but in case you are asked to respond, that way your testimony will be under oath.

I understand that there is one statement.

STATEMENT OF JUDY A. ENGLAND-JOSEPH, DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RICK HALE, ASSISTANT DIRECTOR, RCED DIVISION, AND CHRISTINE FISHKIN, EVALUATOR IN CHARGE, RCED DIVISION

Ms. ENGLAND-JOSEPH. Yes, sir. There is one statement and they are here to assist me with answering any questions you might have.

I would like to start by thanking you for having this hearing. We welcome the opportunity to testify on the proposals that are before you and others regarding the situation that faces the Department of Housing and Urban Development, particularly their multifamily section 8 portfolio.

I would like to start with a video that we developed, largely based on the need to illustrate visually the type of properties that we are talking about in this portfolio. We went to 10 case study locations. They are a part of the larger sample that HUD developed through their Ernst & Young study, which we will talk about later, and it has a description about the problem and the situation that faces us all with this particular inventory. So we will start with that first.

[Videotape presentation.]

Ms. ENGLAND-JOSEPH. As you can see, we thought it would be useful to have you see what we saw as we visited these properties; and to see the full range of properties that exist out there probably encourages an approach that is not one-size-fits-all, but something that recognizes the uniqueness of each property.

I will summarize my remarks. Thank you for including my full statement in the record.

As you said when you opened—in your opening remarks, sir, in May 1995, HUD proposed a process called Mark to Market that was aimed at addressing the problems of this particular portfolio; and in early 1996, HUD modified that process to respond to stakeholders' concerns and renamed it "Portfolio Re-engineering." My statement is based on previous work we have carried out on HUD's multifamily portfolio and also provides you with some preliminary results of our work on an assignment related to HUD's proposals.

In addition to background that is provided in my statement, the statement also discusses five issues, a couple of which I would like to highlight.

The first issue is the problems currently affecting the portfolio; the second is HUD's plans for addressing these problems; the third, a HUD-contracted study by Ernst & Young that estimates how the properties are likely to be affected by HUD's re-engineering proposal; fourth, our preliminary assessment of the Ernst & Young study; and finally, issues facing the Congress in deciding how to respond to HUD's proposal. We also are providing some observations on HUD's Portfolio Re-engineering initiative.

In summary, we found the basic problems affecting the insured section 8 portfolio are high subsidy costs, high exposure to insurance loss, and the poor condition of many of these properties. In 1995, when HUD proposed to address these problems through a process called Mark to Market, there were a number of questions and concerns that were raised about that proposal, including whether data on the physical and financial condition of properties in the portfolio were reliable, how the process would affect the properties and existing residents, and whether the results would be a net savings or a cost to the Government. Without this information, it was difficult to predict the overall effects of HUD's Mark to Market proposal on the properties, their owners, the residents, and the Federal Government. So in 1995, HUD contracted with Ernst & Young to obtain up-to-date information on market rents and the physical condition of the properties in the insured section 8 portfolio and to develop a financial model to show how HUD's proposal would affect the properties.

Assistant Secretary Retsinas I know will speak in much greater detail on the Ernst & Young study, but I would like to highlight several points based on the work we did.

The Ernst & Young May 1996 report on the Department's proposal indicates that the vast majority of the insured section 8 properties; that is, between 77 and 83 percent would need to have their debt reduced in order to continue operations. The data also indicate that between 22 and 29 percent of the properties in this portfolio would have difficulty sustaining operations even if their mortgages were totally forgiven.

The study also confirms earlier data that for most of the properties subject to Portfolio Re-engineering the assisted rents are higher than the estimated market rents. In addition, the portfolio of properties were found to have significant amounts of immediate deferred maintenance and short- and long-term capital needs.

Our preliminary analysis of the Ernst & Young financial model indicates that it provides a reasonable framework for studying the outcomes of Portfolio Re-engineering, such as how many properties will need to have their debt reduced. In addition, we did not identify any substantive problems with Ernst & Young's sampling and statistical methodology.

We are currently examining their data on subsidy and claims costs that were developed by Ernst & Young as a part of the study, but were not included in the May 1996 report. Our preliminary analysis of that cost data indicates that the claims costs will be substantial. Ernst & Young's data indicate that the average debt write-down for properties whose mortgages need restructuring is approximately 61 to 67 percent of the insured loans' unpaid principal balance at the time of restructuring.

The Congress will face a number of key issues beyond these in considering HUD's Portfolio Re-engineering proposal, but there are a few that we wanted to highlight today. How will we address HUD's problems in managing the insured section 8 portfolio? To what extent should FHA insurance be provided as a part of these restructured loans? Should rental assistance be project-based or tenant-based? What protections should be given to households as re-engineered properties occur? To what extent should properties with assisted rents below local market rents be included in Portfolio Re-engineering? What process or processes should be used to actually restructure these mortgages? To what extent should the Federal Government finance rehabilitation costs? How should HUD address the large number of properties that would have difficulty sustaining operations? To what extent should the Government provide tax relief to owners affected in the Portfolio Re-engineering? And finally, will the demonstration program that you discussed in your opening remarks cover the full range of options and outcomes?

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

In terms of our observations, HUD's Portfolio Re-engineering initiative recognizes a reality that has existed for some time; namely, that the value of many of the properties in this insured section 8 portfolio is far less than the mortgages on those properties would suggest. Until now this reality has not been recognized, and the Federal Government has continued to subsidize the rents at many properties above the level that the properties could command in a commercial real estate market.

As the Congress evaluates options for addressing this situation, it will be important to consider each of the fundamental problems that have affected the portfolio and their underlying cause. Any approach implemented should address not only the high section 8 subsidy costs, but also the high exposure to insurance loss, the poor physical condition, and the underlying causes of these longstanding problems with the portfolio.

Questions about the specific details of the re-engineering process, such as which properties to include and whether or not to provide FHA insurance, will require weighing the likely effects of those decisions on various options and the tradeoffs involved when proposed solutions achieve progress on one problem but perhaps at the expense of another. Changes to the insured section 8 portfolio should also be considered in the context of a long-range vision of the Federal Government's role in providing housing assistance and assistance in general to low-income individuals and how much of a role the Government is realistically able to give in the current budgetary climate.

Mr. Chairman, that represents the summary of my comments, and we stand ready to respond to you or any members of your subcommittee.

[The prepared statement of Ms. England-Joseph follows:]

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to testify before this Subcommittee as it examines the management and cost implications of proposals to reengineer about 8,600 properties from the Department of Housing and Urban Development's (HUD) multifamily rental housing portfolio. These 8,600 properties, which we refer to as the insured Section 8 portfolio, are properties that receive mortgage insurance from HUD through its Federal Housing Administration (FHA) and that receive Section 8 rental subsidies that are tied directly to the properties (Section 8 project-based assistance). Two years ago, we testified at a hearing held by this Subcommittee's predecessor concerning the problems affecting HUD's Section 8 properties, including high Section 8 assistance costs and poor physical conditions at many properties.[1]

Subsequently, in May 1995, HUD proposed a process called "mark-to-market" that was aimed at addressing these and other problems. In early 1996, HUD modified that process in response to stakeholders' concerns and renamed it "portfolio reengineering." This statement is based on previous work we have carried out on HUD's multifamily portfolio and also provides the preliminary results of our work on an assignment relating to HUD's proposals. In addition to providing background information on the insured Section 8 portfolio, this statement discusses (1) the problems currently affecting the portfolio, (2) HUD's plans for addressing these problems, (3) a HUD-contracted study by Ernst & Young LLP that estimates how the properties are likely to be affected by HUD's reengineering proposal, (4) our preliminary assessment of Ernst & Young's study, and (5) issues facing the Congress in deciding how to respond to HUD's proposal. We are also providing observations on HUD's portfolio reengineering initiative.

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

In summary, we found the following:

- The basic problems currently affecting the insured Section 8 portfolio are much the same as those we discussed 2 years ago–high subsidy costs, high exposure to insurance loss, and the poor condition of many properties. These problems stem from one or more of several basic causes. These include (1) program design flaws that have contributed to high subsidies and put virtually all the insurance risk on HUD and (2) weaknesses in HUD's oversight and management of the insured portfolio, which have allowed physical and financial problems at a number of HUD-insured multifamily properties to go undetected or uncorrected.

- HUD's mark-to-market proposal sought to address these problems and their causes by decoupling HUD's mortgage insurance and project-based rental subsidies and subjecting the properties to the forces and disciplines of the commercial market. The process would allow property owners to set rents at market levels, while HUD would reduce mortgage debt if necessary to permit a positive cash flow, terminate FHA's mortgage insurance, and replace project-based Section 8 subsidies with portable tenant-based subsidies. Although HUD expected the proposal to reduce the costs of Section 8 subsidies, lowering mortgage debt would result in claims against FHA's insurance fund. In response to various concerns about its mark-to-market proposal, in early 1996 HUD made several changes to the proposal but left most of its basic thrust intact.

- During 1995, HUD also contracted with Ernst & Young LLP to obtain up-to-date information on market rents and the physical condition of the properties in the insured Section 8 portfolio and to develop a financial model to show how HUD's proposal would affect the properties. Ernst & Young's May 1996 report on the Department's proposal indicates that the vast majority of the insured Section 8 properties–between 77 and 83 percent–would need to have their debt reduced in order to continue operations. The data also indicate that between 22 and 29 percent of the properties in the portfolio would have difficulty sustaining operations even if their mortgages were totally forgiven. It is important to note that the study's results reflect the provisions contained in HUD's mark-to-market proposal prior to the changes that HUD made to the proposal in early 1996.

- Our preliminary analysis of Ernst & Young's financial model indicates that it provides a reasonable framework for studying the outcomes of portfolio reengineering, such as how many properties will need to have their debt reduced. In addition, we did not identify any substantive problems with Ernst & Young's sampling and statistical methodology. We are still assessing how assumptions used in the model affect its estimates of the effects of portfolio reengineering. Our analysis of the cost data that were developed by Ernst & Young as part of its study but not included in its May 1996 report indicates that the claims costs will be substantial–between $6 billion and $7 billion on a present value basis. This amount reflects an average debt writedown of approximately 61 to 67 percent of the insured loans' unpaid principal balances at the time of restructuring for properties whose mortgages need restructuring.

- The Congress will also face a number of other key issues in considering HUD's portfolio reengineering proposal. These include (1) whether rental assistance should be project-based or tenant-based, (2) what protection should be given households that could be displaced as a result of reengineering, (3) to what extent FHA insurance should be used for restructured loans, and (4) to what degree the federal government should finance rehabilitation costs.

BACKGROUND ON THE PORTFOLIO

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

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

According to HUD, its restructuring proposals apply to 8,636 properties that both have mortgages insured by FHA and receive project-based Section 8 rental subsidies for some or all of their units. Data provided by HUD in April 1996 show that, together, these properties have unpaid principal balances totaling $17.8 billion and contain about 859,000 units, of which about 689,000 receive project-based Section 8 subsidies.[3] According to HUD's data, about 45 percent of the insured Section 8 portfolio (3,859 properties, 303,219 assisted units, and $4.8 billion in unpaid loan balance) consists of what are called the

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

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

"older assisted" properties. These are properties that were constructed beginning in the late 1960s under a variety of mortgage subsidy programs, to which project-based Section 8 assistance (Loan Management Set Aside) was added later, beginning in the 1970s, to replace other subsidies and to help troubled properties sustain operations. About 55 percent of the insured Section 8 portfolio (4,777 properties, 385,931 assisted units, and $13.0 billion in unpaid loan balance) consists of what are called the "newer assisted" properties. These properties generally were built after 1974 under HUD's Section 8 New Construction and Substantial Rehabilitation programs and received project-based Section 8 subsidies based on formulas with automatic annual adjustments, which tended to be relatively generous to encourage the production of affordable housing.

There is great diversity among the properties in HUD's insured Section 8 portfolio, as illustrated by 10 properties that we studied in greater depth as part of our current assignment (see app. I). These properties differ in a number of important respects, such as the amount of their remaining unpaid mortgage debt; the types and amounts of assistance they receive from HUD; and their financial health, physical condition, rents, types of residents served, and surrounding neighborhoods and rental housing markets. These factors can influence the effect that HUD's or other reengineering proposals would have on the properties.

PROBLEMS AFFECTING THE PORTFOLIO

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

A substantial number of the properties in the insured Section 8 portfolio now receive subsidized rents above market levels, many substantially above the rents charged for comparable unsubsidized units. For example, at one of our case study properties, Universal City in Chicago, Illinois, subsidized rents for the 160 Section 8 units range from

$1,017 to $1,469 per month compared to estimated market rents that the property could command of $520 to $750 per month. This problem is most prevalent in (but not confined to) the "newer assisted" segment of the portfolio, where it stems from the design of the Section 8 New Construction and Substantial Rehabilitation programs. The government paid for the initial development or rehabilitation of these properties under these programs by initially establishing rents above market levels and then raising them regularly through the application of set formulas that tended to be generous to encourage the production of new affordable housing. It has become difficult to continue the high subsidies in the current budget environment.

A second key problem affecting the portfolio is the high risk of insurance loss. Under FHA's insurance program, HUD bears virtually all the risk in the event of loan defaults. At one of our case study properties, Onterie Center, also in Chicago, Illinois, HUD insures a $49 million mortgage and holds another $26 million in mortgage debt that was assigned to the Department in 1992 because of continuing financial difficulties at the property.[4] A third, closely related problem is the poor physical condition of many of the properties in the portfolio. For example, Ernst & Young estimates that one of our case study properties, Murdock Terrace in Dallas, Texas, has $5.9 million in immediate deferred maintenance and short-term capital needs. A 1993 study of multifamily rental properties with FHA-insured or HUD-held mortgages found that almost one-fourth of the properties were "distressed." Properties were considered to be distressed if they failed to provide sound housing and lacked the resources to correct deficiencies or if they were likely to fail financially.

The problems affecting HUD's insured Section 8 portfolio stem from several causes. These include (1) program design flaws that have contributed to high subsidies and put virtually all the insurance risk on HUD; (2) HUD's dual role as mortgage insurer and

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[4]This property includes commercial space and 594 residential units, 119 of which have Section 8 project-based assistance.

rental subsidy provider, which has resulted in the federal government averting claims against the FHA insurance fund by supporting a subsidy and a regulatory structure that has masked the true market value of the properties; and (3) weaknesses in HUD's oversight and management of the insured portfolio, which have allowed physical and financial problems at a number of HUD-insured multifamily properties to go undetected or uncorrected.

HUD'S PLANS FOR ADDRESSING PROBLEMS WITH THE PORTFOLIO

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

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

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

After reviewing HUD's proposal, various stakeholders raised questions and concerns about the proposal, including the effect that it would have on different types of properties and residents, and the long-term financial impact of the proposal on the government. In response to stakeholders' concerns, HUD made several changes to its proposal and also renamed the proposal "portfolio reengineering." The changes HUD made included (1) giving priority attention for at least the first 2 years to properties with subsidized rents above market; (2) allowing state and local governments to decide whether to continue Section 8 project-based rental subsidies at individual properties after their mortgages are restructured or switch to tenant-based assistance; and (3) allowing owners to apply for FHA insurance on the newly restructured mortgage loans. In addition, HUD stated a willingness to discuss with the Congress mechanisms to take into account the tax consequences related to debt forgiveness for property owners who enter into restructuring agreements. More recently, HUD has also suggested that action should be deferred on properties that would not be able to generate sufficient income to cover operating expenses after reengineering until strategies are developed that address the communities' and residents' needs relating to the properties.

On April 26, 1996, HUD received legislative authority to conduct a demonstration program to test various methods of restructuring the financing of properties in the insured Section 8 portfolio.[5] Participation in the program is voluntary and open only to properties that have rents which exceed HUD's fair market rent (FMR) for their locality.[6] The purpose of the demonstration is to test the feasibility and desirability of properties meeting their financial and other obligations with and without FHA insurance, with and without above-market Section 8 assistance, and using project-based assistance or, with the consent of the property owner, tenant-based assistance. The demonstration program is limited by law to mortgages covering a total of 15,000 units, or about 2 percent of the total units in the insured Section 8 portfolio. An appropriation of $30 million was provided to fund the cost of modifying loans under the program, which remains available until September 30, 1997. HUD believes that this funding level could limit the number of properties that can be reengineered under the demonstration. On July 2, 1996, HUD issued a public notice announcing the program and providing initial guidance on how it plans to operate the program.

On May 21, 1996, the Senate Committee on Banking, Housing, and Urban Affairs issued a Staff Discussion Paper to outline a general strategy for addressing the problems with HUD's insured Section 8 portfolio. Among other things, the staff proposed to continue project-based Section 8 assistance and to subsidize rents at 90 percent of FMR (or at higher budget-based rents in certain cases if the FMR-based rents would not cover the costs of operation). On June 27, 1996, the Subcommittee on Housing Opportunity and Community Development held a hearing on the staff's proposals, and as of mid-July the Subcommittee was drafting a restructuring bill.

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

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

OBJECTIVES AND RESULTS OF ERNST & YOUNG'S STUDY

In May 1995, when HUD proposed the mark-to-market initiative, the Department did not have current or complete information on the insured Section 8 portfolio upon which to base assumptions and estimates about the costs and impact of the proposal. For example, HUD lacked reliable, up-to-date information on the market rents the properties could be expected to command and the properties' physical conditions–two variables that strongly influence how properties would be affected by the mark-to-market proposal. To obtain data to better assess the likely outcomes and costs of the mark-to-market proposal, HUD contracted with Ernst & Young LLP[7] in 1995 for a study on HUD-insured properties with Section 8 assistance to (1) determine the market rents and physical condition of the properties and (2) develop a financial model to show how the proposal would affect the properties and to estimate the costs of subsidies and claims associated with the mark-to-market proposal.

The study was conducted on a sample of 558 of 8,363 properties and extrapolated to the total population of 8,563 properties identified by HUD at that time as representing the population subject to its mark-to-market proposal.[8] The sample was designed to be projectible to the population with a relative sampling error of no more than plus or minus 10 percent at the 90-percent confidence level. A briefing report summarizing the study's findings was released by HUD and Ernst & Young on May 2, 1996. It provides current information on how the assisted rents at the properties compare with market rents, the physical condition of the properties, and how the properties are expected to be affected by HUD's proposal as the proposal existed while the study was under way. As such, it is

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

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

important to note that the study's results do not reflect the changes that HUD made to its proposal in early 1996.

Study Confirms Excess Subsidy Costs
and Significant Physical Needs at Properties

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

Study Indicates a Significant Level
of Debt Restructuring Would Be Needed

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[9]The study defines capital needs as the cost of improvements needed to bring properties into adequate physical condition to attract uninsured market rate financing. Three categories of capital needs are defined: (1) immediate deferred maintenance, the estimated costs to bring all property operating systems up to market conditions and lender underwriting standards; (2) the short-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in 5 or fewer years; and (3) the long-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in more than 5 years.

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

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

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

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

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

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

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

The case study properties we examined reflect the full range of possible outcomes. Ernst & Young's model concluded that two of the case study properties would fall into the performing category, two were classified in the restructure category, three were full write-offs, and two were classified as nonperforming.[11]

[11]One of our 10 case study properties was dropped from Ernst & Young's sample prior to their final analysis.

MODEL RESULTS INDICATE EVENTUAL
SECTION 8 SAVINGS BUT HIGH CLAIMS COSTS

Ernst & Young's model provides estimates of Section 8 subsidy costs before and after reengineering and the amount of the FHA insurance claims resulting from writing down the properties' mortgages and addressing deferred maintenance needs, although in a manner that does not conform with budget rules or scoring methodology. The May 2, 1996, briefing report does not present the information gathered in the study on how portfolio reengineering would affect rental subsidy and claims costs. According to the Deputy Assistant Secretary for Operations, HUD Office of Housing, while the Department plans to use Ernst & Young's cost data in developing future budget estimates relating to portfolio reengineering, it never intended that the cost data be included in Ernst & Young's May 1996 report.

In the model, claims costs include the amount of debt reduction needed for the property to sustain operations at market rents and also include funding for some or all of the immediate deferred maintenance and short-term capital needs. However, the claims costs are limited to a maximum of the unpaid principal balance of the loans at the time of debt restructuring. In addition, the claims costs are based on an evaluation of the loan amount the property could support using standard financial underwriting criteria without the continuation of FHA insurance.

Our analysis of these data indicates that, while Section 8 costs would decrease over the long-run, there may be little or no aggregate savings in Section 8 rental assistance costs over the next 10 years if, as the model assumes, all insured Section 8 properties were reengineered when their current Section 8 contracts expire. These data indicate that, for the period fiscal year 1996 through 2005, there may be little difference in aggregate Section 8 costs after reengineering compared with the cost of continuing project-based assistance at current levels:

- If project-based assistance is continued at current levels (including inflation), the costs in present value terms are estimated to be between $27.2 billion and $31.0 billion.[12]

- The cost of Section 8 assistance after reengineering is estimated to be between $26.5 billion and $29.8 billion.[13]

A primary reason that 10-year Section 8 cost estimates are similar is that the model assumes that projects will be reengineered when their current Section 8 contracts expire. This analysis thus reflects HUD's contractual obligations, which the Department has repeatedly indicated that it will not abrogate. Because many properties with rents below market have expiring contracts during the first part of the 10-year period and thus will be reengineered early in the process, Section 8 costs increase during the early years but then begin to decrease as more projects with rents above market are reengineered in the later years. In fiscal year 2005, when Ernst & Young assumes that virtually all projects have been reengineered, Section 8 costs are estimated to be between $1.9 billion and $2.2 billion a year on a present value basis. The model indicates that annual savings of between $298 million to $493 million (between 13 to 19 percent) could be achieved with reengineering compared with the costs of continuing Section 8 assistance at current levels.

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[12]These and other total cost estimates contained in our statement are based on a universe of 8,363 properties–the population from which the sample used by Ernst & Young was selected. The estimates contained in Ernst & Young's May 1996 report are based on a population of 8,563 properties. The difference reflects properties that did not have a chance at being included in the sample due to technical and cost considerations. In general, the estimates in our report would increase by about 2 percent if they were applied to 8,563 rather than 8,363 properties. This assumes that the additional properties HUD identified are similar to those in the original population.

[13]Both estimates assume Section 8 costs increase by 3 percent a year. We discounted these costs by 6.75 percent a year to arrive at a present value estimate.

However, we note that Ernst & Young's model does not reflect the changes that HUD made to its proposal in early 1996. Some of the changes offer the potential of additional Section 8 cost savings. For example, HUD is proposing to use a proactive approach to portfolio reengineering and hopes that owners will voluntarily agree to go through this process (and terminate the Section 8 contracts) in advance of Section 8 contract expirations. However, it is not clear to what extent HUD will be successful in attracting owners to restructure in advance of the Section 8 contract expirations--or what additional incentives HUD may have to offer to achieve this goal.

In addition, HUD now plans to focus initially on reengineering properties with rents above market. To the extent that portfolio reengineering focuses on such properties, Section 8 savings would increase. For example, Ernst & Young's data indicate that the 10-year Section 8 costs for properties with assisted rents above market would be between $21.2 billion and $25.0 billion compared with between about $18.5 billion and $21.5 billion if the loans for properties with rents above market were restructured when the Section 8 contracts expire.[14] Furthermore, it is important to note that some savings would result if, as Ernst & Young's model assumes, mortgage interest subsidies are terminated as projects are reengineered. Ernst & Young estimates that without reengineering, mortgage interest subsidies would range from between about $841 million to $1.1 billion over the next 10 years (on a present value basis). However, it should be noted that most properties that receive interest subsidies are believed to have rents that are below market.

Regarding the FHA insurance claims costs, our analysis of Ernst & Young's data indicates that FHA claims for mortgage write-downs and deferred maintenance and other capital

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[14]All estimates for projects with assisted rents above or below market rents based on the Ernst & Young sample may be misstated because the sample did not contain both types of properties in each of the groups of properties, called strata, from which they sampled. Thus, the estimates assume that none of the 510 projects from three strata containing newer projects had assisted rents below market. The estimates also assume that none of the 372 older projects from two strata were above market.

costs for properties that need mortgage restructuring will be substantial. The mortgage balances for properties needing mortgage restructuring–including those in the full write-off and nonperforming categories that would have their mortgages totally written off–would need to be reduced by between 61 to 67 percent. This reduction would result in claims costs against the FHA multifamily insurance funds. According to the data, the 10-year costs of claims paid, on a present value basis, would be between $6 billion and $7 billion. If HUD's proactive approach were successful, while Section 8 savings would increase, the claims amounts related to debt write-down could also be higher than indicated in Ernst & Young's study because (1) the loans would be restructured earlier when the unpaid principal balances are higher and (2) the present value of claims occurring in the earlier years would be higher. However, HUD believes that without a proactive approach, owners will disinvest in the properties. Such disinvestment would have an adverse impact on the physical condition, resulting in higher claims costs for deferred maintenance.

The claims payments estimated in Ernst & Young's study indicate substantial loan loss rates for the government.[15] For example, portfolio reengineering claims for properties with assisted rents greater than market rents are estimated to be between $4.8 billion and $5.8 billion, and the related unpaid principal balances at the time of restructuring are between $6.9 billion and $8.1 billion. The estimated loss rate would be between 67 and 75 percent. Table 2 provides claims, unpaid principal balance, and recovery data for the properties subject to portfolio reengineering.

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[15]The loss rate represents the ratio of claims to the unpaid principal balances at restructure dates.

Table 2: Impact of Portfolio Reengineering on FHA's Insurance Fund, Fiscal Years 1996-2005[a]

Dollars in billions (present value)

Relative value of assisted rents before restructuring	Claims	Unpaid principal balances at date of restructuring	Loss rate
Greater than or equal to market rents	Between $4.8 and $5.8	Between $6.9 and $8.1	67% to 75%
Less than market rents[b]	Between $1.0 and $1.5	Between $2.2 and $3.1	40% to 51%
Total	**Between $6.0 and $7.0**	**Between $9.5 and $10.8**	**61% to 67%**

[a]All estimates for projects with assisted rents above or below market rents based on the Ernst & Young sample may be misstated because the sample did not contain both types of properties in each of the groups of properties, called strata, from which they sampled. Thus, the estimates assume that none of the 510 projects from three strata containing newer projects had assisted rents below market. The estimates also assume that none of the 372 older projects from two strata were above market.

[b]This estimate may be misstated because no projects with claims were found among the sampled projects with assisted rent less than market rent from four strata. Thus, the estimate assumes that none of the 985 projects from these strata were projects with assisted rents less than market rents that resulted in claims. The 985 projects included 807 newer and 178 older projects.

GAO'S ASSESSMENT OF THE MODEL AND THE RESULTS

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

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

In addition, Ernst & Young's May 1996 report does not detail all of the assumptions used in the firm's financial model that are useful to understanding the study's results. In particular, the model assumes that the interest subsidies that some properties currently receive will be discontinued after the first Section 8 contract expires, including those in the performing category whose debts do not require restructuring. Furthermore, the financial test identifying the loans that could cover all debt service, operating, and capital needs costs if market rents replaced assisted rents, assumes that properties that currently receive interest subsidies would have to pay the full mortgage interest amount without the benefit of the interest subsidy. This assumption would identify fewer performing loans than if the current debt service requirements were tested for. We are currently examining how the assumptions contained in Ernst & Young's study affect its estimates of the effects of portfolio reengineering. In addition, as discussed in appendix II, we also performed sensitivity analyses to assess the extent to which the use of different assumptions affects the results of Ernst & Young's study.

As part of our work evaluating the Ernst & Young model, we also compared Ernst & Young's data on market rents and deferred maintenance with information from the three licensed appraisal firms we retained to assess 10 of the HUD-insured Section 8 properties included in Ernst & Young's sample. In 8 out of the 10 cases, the estimated market rents provided by these appraisers are reasonably close to (i.e., within 10 percent of) the rents Ernst & Young developed in their market surveys. In two instances, however, Ernst & Young's market rent estimates are more than 20 percent lower than the market rent estimates of the appraisal firms. This difference reflects in large measure a different methodology that Ernst & Young used in estimating market rents in neighborhoods consisting primarily of assisted properties--where few, if any, comparable market properties were identified. In these cases, Ernst & Young assumed that since the local neighborhood was essentially maintained by non-market driven forces, there was no market for unassisted rents in these neighborhoods other than that controlled by the local housing authority. Thus, Ernst & Young based its rent estimates on the rents subsidized by the local housing authorities. In contrast, the appraisers we retained believed that there were comparable properties that could be used to estimate market rents for the two properties.

While the information we had on the market rents for our 10 case studies was generally consistent with Ernst & Young's estimates, the information on capital needs costs varied widely. In general, the Ernst & Young cost estimates were significantly higher. The appraisers we retained conducted physical inspections of the properties but were not tasked with performing engineering studies. In contrast, Ernst & Young retained a firm to conduct engineering studies at the properties. Officials from Ernst & Young and the engineering firm said the inspections were not full engineering studies which would be used in financial underwriting or negotiations with the owners. However, the inspections provide preliminary data that can be used for budgeting purposes. Because the appraisals conducted for us were more limited in scope than Ernst & Young's reviews and thus not directly comparable, we provided the property owners and managers with the capital needs estimates developed by Ernst & Young and by the appraisers for their evaluation. We are currently examining their responses and the reasons for the differences in the capital needs estimates.

COMPLEX ISSUES WILL SHAPE THE POTENTIAL OUTCOMES OF REENGINEERING

The Congress faces a number of significant and complex issues in evaluating HUD's portfolio reengineering proposal. How these issues are resolved will, to a large degree, determine the extent to which the problems that have long plagued the portfolio are corrected and prevented from recurring and the extent to which the restructuring process results in any net savings to the government. Key issues include the following:

- How should HUD's problems in managing the insured Section 8 portfolio be addressed?

- To what extent should FHA insurance be provided for restructured loans?

- Should rental assistance after reengineering be project-based or tenant-based?

- What protection should be given to residents of reengineered properties to protect them from rent increases or displacement?

- To what extent should properties with assisted rents that are below market rents be included in portfolio reengineering?

- What process or processes should be used to restructure mortgages?

- To what extent should the federal government finance rehabilitation costs?

- What actions should be taken to deal with properties that would have difficulty in sustaining operations after portfolio reengineering?

- Whether and to what extent should tax relief be provided as a part of the reengineering process?

- Will the current demonstration program be sufficient to test the range of options for carrying out portfolio reengineering and its effects on properties and residents?

These issues are discussed further in appendix III.

OBSERVATIONS

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

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

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

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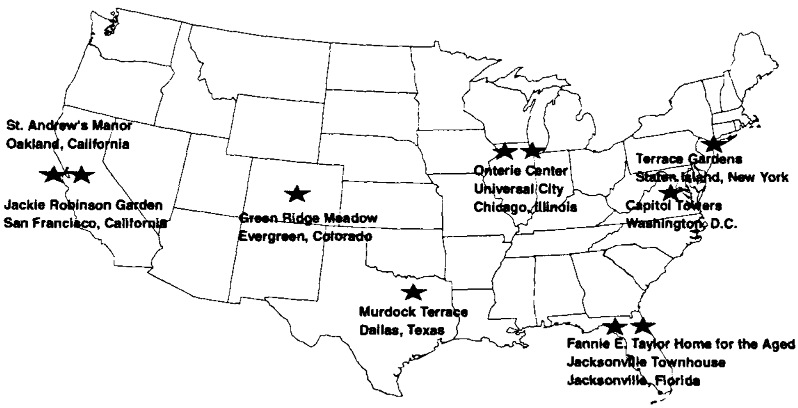
As indicated earlier in our statement, we are continuing to review the results of Ernst & Young's study and other issues associated with portfolio reengineering, and we will look forward to sharing the results of our work with the Subcommittee as it is completed.

GAO'S 10 CASE STUDY PROPERTIES

Figure 1.1: Names and Locations of Case Study Properties



SENSITIVITY ANALYSIS HELPS EVALUATE THE RANGE OF POSSIBLE OUTCOMES

Any estimates of the outcomes and costs of portfolio reengineering are likely to be subject to some error because they rely on predicting the reactions of numerous owners, lenders, and residents. In addition, as discussed above, we have identified some limitations of the model and some assumptions that may not reflect the way in which insured Section 8 properties will actually be affected by portfolio reengineering. To assess the extent to which the use of different assumptions affects the results of Ernst & Young's study, we performed sensitivity analyses of Ernst & Young's model using two sets of revised assumptions that we developed on the basis of our discussions with multifamily industry officials. One scenario reflects assumptions that are more optimistic in terms of the cost to the government of portfolio reengineering. The other uses assumptions that are more conservative or pessimistic. Both of these sets of assumptions are intended to reflect the range of potential outcomes using the same basic policy assumptions used in the Ernst & Young study. We recognize that the use of alternative policy assumptions can produce different outcomes.

For the optimistic scenario, we used financing terms that the lenders we consulted believed to be the most favorable that were likely to be available, assuming that no FHA insurance or other credit enhancement is provided. For example, we lowered the range of interest rates applicable to the restructured loans from a range of 9.75 to 10 percent to a range of 8.75 to 9 percent. We also revised the debt service coverage ratios, the loan-to-value requirements, and the loan amortization periods to reflect the views of the lenders. In some cases, our terms, though viewed by lenders as optimistic, are more conservative than Ernst & Young's. In addition, a significant difference between our optimistic scenario and Ernst & Young's analysis is that we reduced all capital costs used by Ernst & Young by 25 percent.

For our pessimistic scenario, we used higher interest rates than Ernst & Young, set higher standards for debt service coverage ratios and loan-to-value requirements, and increased the transaction cost and bad debt expense estimates somewhat. We also reduced Ernst & Young's market rent estimates by 5 percent. We did not adjust the capital cost estimates used in Ernst & Young's study for this scenario.

Under all the scenarios, a substantial number of properties are likely to do well, and other properties will have difficulty sustaining operations. Specifically, using optimistic assumptions, between 24 percent to 30 percent of properties fall into the "performing" category, but between 15 percent and 20 percent fall in the two bottom categories–"full write-off" or "nonperforming." Using the pessimistic assumptions, between 10 and 14 percent would be "performing" and between 39 percent and 46 percent would be "full write-offs" or "nonperforming." The FHA claims costs associated with portfolio reengineering are estimated to be between $4.9 billion and $5.9 billion using optimistic assumptions and between $8.2 billion and $9.4 billion using pessimistic ones. The Section 8 subsidy costs are the same as Ernst & Young's using our optimistic assumptions. Section 8 subsidy costs decrease somewhat using our pessimistic assumptions, where we reduced the estimated market rents by 5 percent.

ISSUES FACING THE CONGRESS IN ASSESSING HUD'S PORTFOLIO REENGINEERING PROPOSAL

The Congress faces a number of significant and complex issues in evaluating HUD's` portfolio reengineering proposal. Key issues include the following.

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

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

To What Extent Should FHA Insurance Be Provided for Restructured Loans?

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

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

Should Rental Assistance Be Project-Based or Tenant-Based

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

What Protection Should Be Given to Households at Reengineered Properties

If a decision is made to convert Section 8 assistance from project-based to tenant-based as part of portfolio reengineering, decisions must also be made about whether to provide additional displacement protection for current property residents. HUD's April 1996 reengineering strategy contains several plans to protect residents affected by rent increases at insured properties. For example, residents currently living in project-based Section 8 units that are converted to tenant-based subsidy would receive enhanced vouchers to pay the difference between 30 percent of their income and the market rent for the property in which they live, even if it exceeds the area's fair market rent ceiling. The residents of reengineered properties who currently live in units without Section 8 subsidy would receive similar assistance if the property's new rents require them to pay more than 30 percent of income. Such provisions are clearly important to help limit residents' rent burdens and reduce the likelihood of residents being displaced, but they also reduce Section 8 savings, at least in the short run. The Ernst & Young study's cost estimates assume that HUD would cover Section 8 assistance costs for existing residents, even if a property's market rents exceed fair market rent levels set by HUD. However, it does not include any costs for providing Section 8 subsidy to residents who are currently unassisted.

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

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

What Process or Processes Should Be Used to Restructure Mortgages

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

To What Extent Should the Federal Government Finance Rehabilitation Costs

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

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

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

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

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

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

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

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Mr. SHAYS. I want to begin this process by understanding a little about—I want to share with you my sense of part of this challenge, and then I want you to correct me, because I think I will need to be corrected.

My sense was that the attitude of Congress years ago was that we could create housing that would service the poor and that eventually this housing would revert to the private owners, who would—and in a sense, we have increased the housing supply; each year we would add to the housing supply, we would provide new projects. In a certain period of time they would go into the private sector, but we would constantly have this new flow of housing. That is one sense that I had.

Another sense was that from the developers' standpoints, a number made an absolute killing by getting these contracts, getting one—in a sense, a guarantee from the Federal Government they would get certain tax write-offs from the State government, they would be able to take out of the project on day one a significant sum that they would then have as their own. They would get a fairly large mortgage, go to HUD with the argument that this mortgage needed to be—they needed a certain income level to pay this mortgage.

In other words, my sense is that the developers basically, not the nonprofit developers but the private sector developers, some were able to take out a lot early on, then during the course of the 20 years, maintain the property with very little income to themselves, with the hope eventually that they would then be able to take over these projects. That obviously is true in areas where they want to take them over.

I can think of a site in downtown Stamford that is commercial, that you could put a high-rise 14-story building on. As soon that mortgage is paid off and they can take control of it, they are going to tear it down and they are going to build a high-rise. I can think of others in the district where nobody would want the project and it would just revert to HUD.

Straighten me out: Once the mortgage is paid off, there is no subsidy in the sense that HUD has to take care of—the mortgage is paid for, but then you are stuck with a facility with people who need a place to live and nobody wants to run the facility. Straighten me out, and I will ask the witnesses that follow to straighten me out as well.

Ms. ENGLAND-JOSEPH. I will start, and Rick and Christine can help me out. I probably would use a slightly different tone in the way I would describe——

Mr. SHAYS. What is the other element? I was embarrassed to even mention it, since I should know it. I had a year-long hearing on it. When you get a tax credit that States could collect in terms of credits, what do we call that?

Ms. ENGLAND-JOSEPH. The low-income housing tax credit.

Mr. SHAYS. And they basically took advantage of the low-income housing tax credit?

Ms. ENGLAND-JOSEPH. There may be some properties that originally were section 236 properties or section 221(d)(3) properties that ultimately sold to new owners, and during that process, tax credits may have been——

Mr. SHAYS. Only in that case. OK.

Ms. ENGLAND-JOSEPH. But in this discussion we probably should separate the low-income housing credit from the discussion.

In terms of Congress and the intent behind Congress and previous administrations with these programs, both what we call older assisted programs that were developed in the early 1960's and then what we call newer assisted, but not so new, that were built starting in the mid-1970's the intent was largely what you are suggesting, to increase the stock of available low-income housing for poor people. But largely the intent was to have the private marketplace come forward and provide that housing, build and finance that housing, manage and own that housing; and the Government was—through insurance and through various other activities, but initially through FHA insurance—was intending to provide a credit enhancement. It was intending to say, we know there is a risk here and we want to insure that risk, but we don't want to be a part of owning this property; we want the private marketplace to own and manage it.

Mr. SHAYS. This happened while I was a State legislator in the 1970's. But in 1983 we discontinued this model, correct?

Ms. ENGLAND-JOSEPH. In the sense that we have no properties that were built after 1983 in these two programs.

Mr. SHAYS. My sense is that you would have to be an idiot not to recognize that when the mortgage was due and someone was free to take the property and do with it as they wanted, they would have many different options. They could try to renegotiate with HUD or try to go into the private sector, correct?

Ms. ENGLAND-JOSEPH. Right. Although I think the intent behind this was to maintain the stock for a long period of time, and that is why there were section 8 project-based assistance that ultimately were linked with these properties, with long contracts that were in some cases 30-plus years in length. That was intended to try to guarantee a stream of income into these properties so that the property owner would see the benefit, obviously, of maintaining this as a property for low-income populations.

The difficulty came in when these properties began to decline or for many reasons, not the least of which was, when developers got into these programs, there was a tax benefit, but the tax laws changed and ultimately it wasn't the same benefit as existed when they first entered this program.

In terms of tone, I wanted to be sure that I emphasized that the way you were describing the role of developers and maybe why they got into this program might imply some malice intent or some ulterior motives, and I think other than perhaps financial benefit in terms of tax benefits, there is really no indication from the work that GAO has done that would say that largely developers went into this because they were trying to bilk the Government. I think there was serious intent on the part of many developers to provide affordable, low-income, hopefully high-quality housing.

Mr. SHAYS. Let me, though, ask you, didn't they get a windfall in the beginning years?

Mr. HALE. I think you are right, Mr. Chairman.

Mr. SHAYS. Be clear. The law is the law, and I am not saying they broke the law. I am just saying that we had an absurd circumstance where people were able to take out a large sum in the beginning and then they had to struggle to keep these projects operating, even with the high rents that they received.

Mr. HALE. I think your point is a very important one. You are right, a number of developers were able to make a substantial amount of money. That is the way the program operated.

But the other half of that problem and the one that we face now is that some of those same owners now do not have a lot of financial incentives to maintain the property. They have achieved a lot of their benefits, and that places the Government in the difficult situation of having mortgage insurance and potential defaults on the one hand and continuation of section 8 subsidies on the other hand.

Mr. SHAYS. Anything else before I go to Mrs. Morella? I am going to come back but I want to make sure my sense is consistent with your sense. I am exposing some of my ignorance, but in the process, I am going to do some learning here.

Ms. ENGLAND-JOSEPH. Largely the way you were describing, the circumstances in which developers found themselves in these programs was very little risk with a lot of benefit and a guarantee from the Federal Government providing them financial and other types of assistance.

Mr. SHAYS. The Federal Government insuring the property. And they are also providing the tenants who are in the property that the only way that they can guarantee that their mortgage is going to be paid is to make sure that there is a high rent in the property but the high rent is higher than the market rent in many instances.

Ms. ENGLAND-JOSEPH. Yes.

Mr. SHAYS. And yet the projects—and not all of them; you show some beautiful ones, but there is really no reason why every one of these developments shouldn't be like some of the better ones if we had designed the program right from day one.

Ms. ENGLAND-JOSEPH. There are a lot of circumstances when you take it down to the property or development level that might affect that property's financial condition, so it is difficult to generalize and say that every property should look like some of the best properties on that video.

Largely, it is driven by the percentage of people that you have that are low-income versus moderate or higher income, if you have a mixed income population. A lot depends on the location of the property and many of the things associated with good management, but largely the rent structure that existed under the older assisted portfolio, which are the older properties; and the way in which those rents were increased, they were not increasing at the same rate and to the same degree that you might be thinking as the newer assisted portfolio where those rents are very, very high in contrast with market rents.

Mr. SHAYS. Mrs. Morella.

When you get two Members of Congress touching each other, they have so much to talk about.

Mrs. MORELLA. So many regional concerns. We are trying to solve all of the problems. The District of Columbia was one of your

10 areas, so we have Virginia, Maryland, et cetera. This is a very important briefing.

I wonder if you would like to tell us what you estimate the savings would be, the near-term and actually the long-term savings to the Government as a result of the section 8 multifamily portfolio, that Portfolio Re-engineering?

Mr. HALE. The best estimates that we can provide are the ones that come out of the Ernst & Young study. I think the numbers that we talked about in the testimony, in our written statement, indicate that a lot depends on which properties you restructure and when you restructure them. The study suggests that if you were to restructure all of the properties in the insured section 8 portfolio, both those with rents above market and those with rents below market, that on a present-value basis over 10 years a good point estimate would be that you might save $1 billion over that time period. If you were just to focus on the properties with rents above market that that might grow to $3 billion again on a present-value basis.

That is a bit different than the numbers that HUD has in their budget, and it is because of differences in the way budget scorekeeping works and also differences in assumptions about inflation rates.

Mrs. MORELLA. Would you like to comment on the assumptions and the accuracy of the Ernst & Young figures?

Mr. HALE. In terms of our estimates, subsidies are very closely tied to estimates of current rents on the property, and the market rents and how they would differ. At the 10 properties that we looked at, we hired our own appraisers and they did estimates of the market rents at those properties. In 8 out of the 10 cases, the rents that our appraisers came up with were very close, within 10 percent, of the rents that Ernst & Young came up with.

There were two in which there were some differences, and what that reflects, more than anything, is that market rents will be very difficult to estimate for certain kinds of properties, particularly those that we talked about in our video where there isn't comparable rental housing around or that are in neighborhoods where practically all of the rental housing is assisted housing.

Mrs. MORELLA. With regard to the study, how were the 10 areas with properties chosen?

Mr. HALE. We selected the 10 properties not to try to portray any sort of random sample, because obviously you can't do that for just 10 properties. Based on discussions that we had with congressional staffs, largely in the House and Senate Banking Committees, they felt it would be very useful for us to try to pick out properties that had some different characteristics, so we that could use those not only to help verify one way or the other or show differences from the Ernst & Young study, but also to illustrate how different kinds of properties would be affected. So we tried to pick properties in different locations and also ones, based on the limited information that was available up front, in terms of the rent levels and their physical condition and mortgage balances.

Mrs. MORELLA. Did you want to add anything?

Ms. ENGLAND-JOSEPH. The only thing I would emphasize with the 10 case studies is that we really tried to use them as illustrations to give you examples of what likely could occur with those properties if they were to be marked down using the Mark to Market proposal at that time, and then also to understand the basic characteristics of those properties.

Often, I think, when we talk about Portfolio Re-engineering or Mark to Market, we tend to talk in the abstract and in a very generalized way. I think that is the real value of the work that Ernst & Young and HUD have done in trying to do a generalizable sample to the entire population of the portfolio and our work, which is intended to give a face to these properties and an understanding that each situation can be affected differently depending on which approach and what decisions are made from a public policy perspective.

Mrs. MORELLA. You probably tried to choose the greatest diversity, the most expensive, the least expensive?

Ms. ENGLAND-JOSEPH. There was not a lot of data available about the properties when we first chose them, so I don't want to suggest that there was a science that allowed us to say that we wanted certain things to exist or be obvious as a part of those 10 case studies. In many cases, it was access to information and access to the properties and the fact that we knew enough about those properties that would give us an indication there would be a full range. Until the work was done, we did not know there would be the kind of range that we found.

Mrs. MORELLA. Do you feel you had a handle on the section 8 properties, or do you feel they are elusive in terms of differences?

Ms. ENGLAND-JOSEPH. I think they are elusive. I think that we have learned a lot more through the Ernst & Young effort by HUD, and I think that is what is of great benefit about this hearing and the information that this hearing will certainly bring out.

But that is only a sample of the total, and even though it is generalizable, until you ultimately decide on what type of re-engineering proposal you want to see implemented in the Federal Government and until we actually get down to the deal level, project-by-project negotiation of the deal, we are really not going to know what is going to happen.

Mrs. MORELLA. Thank you.

I yield back, Mr. Chairman.

Mr. SHAYS. Mr. Davis.

Mr. DAVIS. Thank you. Just explain the project-based versus tenant-based subsidies. Is tenant-based more like the vouchers?

Ms. ENGLAND-JOSEPH. It is the portable approach where you, as a tenant having that voucher, can use that voucher in any property that will rent to you with a voucher. And the project-based is linked to the unit, not the individual; so the individuals, if they don't have economic flexibility to move, are stuck there because they realize that if they leave, they do not get further Federal assistance in terms of rental assistance.

Mr. DAVIS. In finding the units where the rents are most likely above the market levels, are they more project-based or tenant-based?

Ms. ENGLAND-JOSEPH. Mainly project-based because tenant-based assistance is driven largely by what we call the fair market rent, which is something that is driven by a formula.

Mr. DAVIS. It seemed that way, except my experience in my county, Fairfax, is that many landlords will not rent to section 8 certificate holders, and as a result, you have some units that are almost all section 8 because they are the only ones that will rent. In that case, it could skew the rents.

Ms. ENGLAND-JOSEPH. It could. There have been different suggestions that in some cases the fair market rent can drive the rent up to some extent in properties that are nearby that property, but largely what we are talking about here in terms of project-based section 8 rents, they are much higher than the market rate in the area surrounding that property and it is for different reasons that that rent is very high.

Mr. DAVIS. Wouldn't just the availability of section 8 certificates spur the private market into creating rental units and create units just because you now have more people who are able to rent than having the Government go in and directly subsidize? Is that the modern experience as opposed to 20 years ago?

Ms. ENGLAND-JOSEPH. It really depends on the location that we are talking about. In very tight markets where they can command higher rents, a private developer may not be interested in renting using section 8, renting to tenants that would have section 8 assistance. They may be able to cash-flow a property that is middle- or upper-income.

Mr. DAVIS. But a certificate, is it a percent of them or is there an actual dollar figure?

Ms. ENGLAND-JOSEPH. The amount that the tenant pays is 30 percent of income. There is a limit, which is the fair market rent, and the difference between the 30 percent of income and the fair market rent is that which the Government then provides in terms of subsidy.

Mr. DAVIS. But you couldn't go into a highly expensive unit and rent at 30 percent is what I am saying.

Ms. ENGLAND-JOSEPH. With a different type of a voucher—there are different types of section 8 vouchers and certificates. There are subsidies, where you can pay more than 30 percent of your income in order to reach something where the rent is higher than the fair market rent.

Mr. DAVIS. There is an issue. Isn't it when we are the main subsidy payers, HUD is the main subsidy payer and, at the same time, has an interest in the insurance as well, it creates a conflict?

Ms. ENGLAND-JOSEPH. Very definitely because the insurance is almost 100-percent insurance on that mortgage, so if that property owner is unable to pay his or her mortgage, he may, or probably will, default on that mortgage and it comes back to the Government. The Government pays the claim on that debt and holds that mortgage, or ultimately it becomes a HUD-held property.

So, yes, the incentive is to continue to pay out of one pocket to provide the rent, so that that property can cash-flow so you don't have to pay out of the other pocket the claim on that mortgage.

Mr. DAVIS. But it moves your operating costs up.

Ms. ENGLAND-JOSEPH. It raises your rents. Your operating costs may not get raised. It depends really on the circumstances of that property.

Mr. DAVIS. The operating costs of the program is what I mean to say.

Do you have any guesstimate, if we were to try to look at what the liability HUD has here, assets over liabilities? Some of these buildings, we will take a loss no matter what happens; it is so skewed that even leveling them, selling them out, it is a money-loser. Any idea of what the total amount might be?

Mr. HALE. Let me answer that this way. The total amount of insurance liability is $18 billion, the total of the unpaid principle balances. What the Ernst & Young study suggests is, again on a present-value basis, if you look at the unpaid principle balances for those loans that are going to need restructuring, that would be about $10 billion and that the claims associated with that would be in the neighborhood of $6.5 billion; in other words, you would lose about 65 cents on the $1 of the unpaid principle balances of those loans when they were restructured. That is their assumption.

We have done sensitivity runs that indicate that under worst-case scenarios that it could get up close to 90 cents on the $1.

Mr. DAVIS. So, worst case, $9 billion?

Mr. HALE. In present-value terms. In nominal terms, it would be more.

Mr. DAVIS. Thanks.

Mr. SHAYS. I am going to ask some more questions. Some of these questions I would be happy if the next two panels respond to.

I am beginning to realize that part of my confusion is that I am coming from an area of the country where I see older units getting extraordinarily high rents for esthetic facilities.

I need to understand a few things here, and I am—I am thinking that one of the big challenges that we have is that at a certain point in time these units will revert to the private sector and therefore will not be available to low-income housing residents.

That is not the issue that you are addressing. It is a gigantic issue in certain parts of the country.

Ms. ENGLAND-JOSEPH. It is a gigantic issue in the sense——

Mr. SHAYS. I am talking about that part of reverting from the low-income housing to when they go private, truly private, and are able to go out into the marketplace. They are going to basically drop, in my judgment, a lot of the low-income residents and try to pick up middle-income and above-middle-income residents in some facilities, in my area of the country.

Ms. ENGLAND-JOSEPH. Right.

Mr. SHAYS. But am I overestimating that problem? Is it just kind of unique to the area of New England?

Ms. ENGLAND-JOSEPH. Well, perhaps the reason why I am having some difficulty responding is that you are speaking as though it is past tense. I think if we talk about portfolio re-engineering, that is one of the questions. Depending on how we design the portfolio re-engineering process, what you are saying——

Mr. SHAYS. Let's just say I am a developer. I own a facility in Stanford, CT, in the middle of the city, and say in 5 years it is coming due. There is not a chance in hell that I am going to renegotiate with HUD to—if I am totally basing it on economics—that I am going to renegotiate with HUD to allow for it to continue as it is. I am going to tear down that building, if I am totally focused on the economics of it, and I am going to put a high-rise or a store or something else.

Now, in my part of the country—and you can tell me, hopefully, if I am typical or not—there are some facilities that are owned by nonprofits, and their motivation is very different. They will continue to rent to lower-income residents and willingly renegotiate with HUD.

Mr. HALE. Mr. Chairman, there is a particular portion of the low-income stock, most of them have 40 year mortgages, and a significant number of the stock——

Mr. SHAYS. I am looking at a lot with 20 years that are trying to convert. There are some legal questions for that.

Mr. HALE. There is a preservation program that tries to provide incentives, as you are well aware of, to keep those properties from prepaying, so they remain a part of the housing stock.

Mr. SHAYS. Do you consider that a minor problem in the scope of what we are looking at?

Ms. ENGLAND-JOSEPH. Well, the difficulty is not knowing how to anticipate the behavior of property owners. What is difficult is to anticipate what might happen in terms of property owners and whether, in fact, the condition of their property and the marketplace in which that property exists will motivate them, either to do what you are suggesting or to continue to stay within the program, because there are perhaps incentives that would be a part of the re-engineering process that would make it lucrative or beneficial for them to stay in.

I truly would not distinguish the nonprofits from the for-profits. I think largely it may be a financial as well as a social decision, depending on the circumstances.

Mr. SHAYS. I missed that last part. Why wouldn't you? The nonprofits are owned by church groups. There is not a likelihood they are going to want to kick out all the residents and prepay and go into the private sector. They are going to keep serving those residents.

Ms. ENGLAND-JOSEPH. Well, a lot would depend on the condition of the property and the marketplace that that property is in. It may be that that nonprofit will continue to provide housing for those tenants somewhere else. It may be that they will find it beneficial to make a huge investment in increasing the value of that property through rehab and keeping the tenants there.

So, again, it is just very difficult to determine, based on what type of owner you are, what actions you might take.

Mr. SHAYS. Well, let me just say to you, I accept part of your testimony, and part of it I just think is totally wrong. I realize this is not the primary focus of this hearing, but this is a part of it.

There are church organizations that own this nonprofit housing that they could prepay and they could do something else. It isn't even in their wildest imaginations to do it.

I have constituents or units within the Fourth Congressional District where our big concern is, they are going to take them out of the market. That hit me from day one when I got elected in 1987. So that is a problem.

Now, the issue though—and we have another problem in areas of the country where we are paying well above the market rate for absolutely shabby conditions. We tell the owner, "Fix up your building." He says, "I don't have enough money." He doesn't have enough money, because he took everything out in the beginning. And I am not saying it is illegal; he just did it. We had a poorly designed program, and he took everything out, or she, and they are just coasting on this property now and are hardly able to pay their bills because they have such a high mortgage, in spite of the fact that HUD is paying a large subsidy.

Now, in those instances, we have very little leverage. We can basically take the residents out and refuse to pay, and they can just let the buildings be there until HUD ultimately takes them over, and we have got a mess. And that is another issue.

Now, I realize that is what I bring to the table. What I am seeing being brought to the table here is that I have got to have an appreciation of older versus newer units, that in fact in some cases we are paying under market rent.

This is a new territory for me, not for you all. My mind has not been in that area. That is the whole purpose of these hearings.

What I am hearing you say is, there are a lot of units that are simply not paying market rent and that ultimately, when the contracts come due, we are going to have to significantly increase the amount of rent which we subsidize, which we do not have the money to do; is that accurate?

Just give me proportions. I am looking at chart 14 and 16 in the Ernst & Young, which is almost two-thirds of properties have assisted rents greater than market rents. It says 63 percent have rents greater than market. It says 37 percent have rents less than market. Tell me the significance of that.

Mr. HALE. It is because of the section 8 program, the fact we are paying subsidies at about two-thirds of the properties that have rents above market. It is because of the budget climate. It has become difficult to sustain the subsidies at those levels, that is one of the main reasons driving this whole concern. There is a need to reduce the section 8 subsidies on those properties. But if you do so, it is going to mean, for many of those properties, they simply can't survive at the lower rents.

Mr. SHAYS. The issue of the greater market rents is, people like me and others are simply going to say we are not going to sustain that. In terms of the 37 percent who have less than market, the issue is that the developer is not going to continue to sustain less than market.

When do they get to decide they are going to renegotiate?

Mr. HALE. For some of the problems, they can do what you were talking about. They can convert the property to a nonassisted property after 20 years. For others, that is not an option. There are properties you are talking about; like the Fannie Taylor property that you saw in our video was a good example. It is a nonprofit property; the rents are low; the property is in good condition.

The problem is, for some of those properties, even though the rents are below market, the properties are not in good condition. That is the real issue facing those—what do we do with those properties?

Mr. SHAYS. And chart 16, could you tell me the significance of the older versus newer?

Mr. HALE. Generally in terms of the rent issue, for the newer assisted properties, those are the properties that generally have high subsidy costs attached to them. About 90 percent have rents that are thought to be above market. For the older assisted properties, it is only about 32, 33 percent that have rents above market. Generally, those have rents below market. I think that is the key difference from a subsidy perspective.

Mr. SHAYS. Basically, about 90 percent of the newer units are getting above market.

Mr. HALE. Yes, sir.

Mr. SHAYS. And 71 percent, greater than 120 percent of the market value.

Mr. HALE. Yes, sir.

Mr. SHAYS. That is mind boggling.

And you agree with that? I don't mean you agree it is adequate, but you agree with Ernst & Young's numbers?

Mr. HALE. Those numbers are pretty consistent with previous work done.

Mr. SHAYS. Let me just have you, and then we will get on to our next witnesses, unless there are some other things you need to tell us. What is—specifically, where do you disagree with the Ernst & Young study?

Mr. HALE. I was going to say, the issues we are looking at very closely, where there were some differences between what our appraisers saw and what Ernst & Young saw, was in the issue of deferred maintenance and capital needs at the properties.

I think part of those differences at least are due to the way that Ernst & Young looked at the capital needs compared to the way we looked at it.

Mr. SHAYS. I need you to get into a little more detail. The significance of this is, we are, in a sense, valuing the properties that exist out there based on what they have as a liability in terms of debt, but also we are looking in terms of what they have in terms of liability in terms of bringing these units up to a livable condition.

Mr. HALE. Basically, what Ernst & Young did—and this is part of the difference—they looked at the property as if to say what really needed to be done to maintain this property for a long time, even in some cases longer than the expected new mortgage on the property. So they looked at both immediate deferred maintenance, short-term, and long-term capital needs of the property.

They also assumed that generally, as a component of the property—for example, appliances or walls or floors—reached the end of its useful life, you would go in and replace those. Our appraisers really just focused more on immediate needs to look at what needed to be fixed at the property now, so that it could compete in the commercial marketplace. So that was a major difference.

So there are some differences also in terms of the specific needs that our appraisers saw and the needs that Ernst & Young saw. We are trying to look through those cases in more detail to get a better understanding.

Mr. SHAYS. I am going to ask the Assistant Secretary and inspector general to respond to this, but I want to nail it down better.

I am looking at chart 7 of the Ernst & Young report. Do you have it there?

Mr. HALE. No. I have it in my briefcase.

Mr. SHAYS. Take your time. I am trying to get a handle on the $18 billion number I was using, just in terms of other factors. What I am looking at is, it looks at the assisted units insured, HUD-held; that is, basically reverted to HUD, page 7.

Mr. HALE. Page 7, OK.

Mr. SHAYS. Why don't you look at it a second before I ask a question.

Mr. HALE. What this is, it provides information on the unpaid principal balances of mortgages.

Mr. SHAYS. I understand what that does, right. But what I wanted to ask next is that the unpaid—I just want to have you be clear with me and for me to clearly understand: The HUD held, was that insured but then HUD picked up?

Mr. HALE. It was defaulted and assigned to HUD; yes, sir.

Mr. SHAYS. So we are looking at a total of either insured or HUD-held of 967,000 units. The unpaid principal on that is $17.8 billion and $2 billion, $2 billion HUD held, for $19.8.

What is the value of these units? In other words, I have no sense of whether this is 50 percent of their value or 25 percent of their value, or what.

Mr. HALE. The value of the properties, that is something that the Ernst & Young study doesn't directly assess. Maybe they have information that could be used to try to come up with the value of the properties, but it is not in any of the reports.

Mr. SHAYS. This is something that I just would like to have a sense of somehow. Then what I would like to know is, I would like to know in terms of Ernst & Young's assessment of the condition of these properties, they were basically saying they needed to spend, what, $9 billion to bring them up?

Mr. HALE. The long- and short-term capital needs of the properties was over $9 billion. Then I think it gets down to $8.3 billion when you take into account the reserves available at the property.

Mr. SHAYS. What was the common assessment before this? Was this a reduction or increase?

Mr. HALE. There hasn't been much of any study previously that tried to go look at this from the same perspective. What this study was trying to do was look and say what really needs to be done at these properties for them to be able to compete without project-based subsidies in the commercial real estate market.

Mr. SHAYS. In other words, if HUD wants to make sure we have little old facilities, long-term, there would have to be an investment of $9 billion? Is that what they are saying?

Mr. HALE. No, not exactly. Again, what they are saying is what these properties would need if you were to pull the subsidies away, which is a bit different from saying, if we were going to keep these as insured project-based subsidies, what do we need to do to fix them up.

Mr. SHAYS. I don't know why the standard would need to be different. We are paying rent. We are wanting to make sure that the people who live there, the residents, have a good facility. So why would it be any different logically?

Mr. HALE. That is a good question you are asking. One of the assumptions that they used—if I can try to talk to you, and it would be good for you to ask them as well—they would assume, if you have a refrigerator and it reaches the end of its useful life at 10 years, you would go in and replace the refrigerator, even if the refrigerator was still operating.

Normally, in the existing HUD-subsidized properties, I don't think you are going to see that happen. As long as the refrigerator is functioning, you would probably keep that in there. That would tend to drive down the estimates to some degree. To what degree, it is difficult to say.

Mr. SHAYS. Do either of my colleagues have any more questions?

Let me just understand if the significance of their deciding that there was basically $8 billion—I will say $9 billion minus the reserves—if that is a significant number in the dialog—it seems to me it is very significant—I would like you to tell me why it is significant.

Mr. HALE. It is very significant because if you look at that as the amount of money that would actually need to go into the properties for them to be able to operate without project-based assistance, what it says is, as you are restructuring these mortgages, in addition to just writing down the mortgage so the property can operate at the reduced rents, if you are lowering market rents, we are also going to have to make a considerable investment in dealing with the physical needs of these properties.

So that is something in addition to just writing down the mortgage to deal with the lower rents.

Mr. SHAYS. Would the developers want that number to be higher or lower?

Mr. HALE. I think the developers would want that number—they would want a thorough assessment of what the capital needs of the properties were.

Mr. SHAYS. They would want it lower, wouldn't they? Wouldn't they?

Mr. HALE. I would think the developers would want it to be high enough to make sure the physical needs of the property are met.

Mr. SHAYS. This is what I am wrestling with. One, if it is a takeover by HUD, HUD would want to say my gosh, these properties—it is a take—I am going to get into this with HUD.

But my sense is that this is a much bigger debate than I am grasping right now, that this is a very key factor here. I am just not quite able to articulate it, because, really, you devalue the property. In one sense, you say this property is not worth anything, if you say it has to be fixed up. In another sense, if you say it is going to be fixed up and it will be HUD's responsibility to get the rent to do it—I see heads go up. Thank you for that affirmation.

Mr. HALE. If I can say one other thing on that point, the point is a very valuable one, because I think it points to the importance, when you are doing the restructuring on these properties, that you do this very carefully and you have people that not only know what they are doing but are looking out for the Government's interest so we are not paying more for rehabilitation costs for the properties and not paying more for operating expenses at these properties than needs to be done. We need to keep those costs down as much as possible, so the properties can survive but we don't waste money in the process.

Mr. SHAYS. The problem is we have to undo some past mistakes. That may be very costly.

Ms. Fishkin, do you have anything you want to say, observing the dialog here?

Ms. FISHKIN. I guess just in terms of talking about the physical condition of the properties and those estimates, that those are very integral into the predictions of what is going to happen in re-engineering—those which will be able to perform without debt restructuring, and, when they have their debt restructured, what that amount is, and that it is important, it is going to be very important, to have good assessments made on these properties.

Mr. SHAYS. That is a helpful comment.

Yes.

Ms. ENGLAND-JOSEPH. If I can say one more thing about whether developers or owners would like to see that number higher or lower. It largely, in my opinion, would depend on who is paying for the rehabilitation and how that rehabilitation is being paid for. They would probably want it higher if they knew it would be a direct grant from the Federal Government, if they were interested in additional cash. They might like it lower if, in fact, it was going to be a part of the way in which the rents were determined and if they felt in any way the long-term rents would not be guaranteed by the Federal Government in some way.

Mr. SHAYS. They would want it lower if they had to pay it. That is really the issue—if they had to pay it.

Well, this has been very helpful to me. I feel like I have been in a true confessional here. Thank you very much.

Our second panel is Mr. Nicolas Retsinas, the Assistant Secretary, Federal Housing Commissioner, Department of Housing and Urban Development; and also Susan Gaffney—here it says "The Honorable Susan Gaffney;" I guess you are both honorable—inspector general, Department of Housing and Urban Development.

[Witnesses: Ms. Gaffney and Messrs. Retsinas, Derecola, and Gittelson, sworn.]

Mr. SHAYS. If other individuals come up, would you identify yourselves for the record?

Ms. DUNLAP. My name is Helen Dunlap.

Mr. GITTELSON. Alan Gittelson.

Mr. SHAYS. Mr. Secretary, it is nice to have you here. I will hear from you first.

Mr. RETSINAS. Thank you, Mr. Chairman.

Mr. SHAYS. This is an important hearing for me. I appreciate your both being here.

STATEMENTS OF NICOLAS RETSINAS, ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING COMMISSIONER, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; AND SUSAN GAFFNEY, INSPECTOR GENERAL, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY DAVID DERECOLA, AUDITOR, OFFICE OF INSPECTOR GENERAL, ALAN GITTELSON, AND HELEN DUNLAP

Mr. RETSINAS. Thank you, Mr. Chairman, and thank you very, very much for holding this hearing. I must confess at the outset——

Mr. SHAYS. You are going to confess to?

Mr. RETSINAS. I said at the outset; I said not throughout. At the outset, Mr. Chairman, let me say I thought your—I was very impressed with the opening statement. I may quibble at a margin or two, but I thought that was as clear a statement of the difficulty in the mountain we need to climb.

As a matter of fact, I thought the particular analogy that you used throughout of the tidal flood or the tidal wave that is approaching was particularly apt, because I must concede, since the last time I appeared before this committee a couple of years ago, I do have this notion sometimes of constantly sticking my finger in the dike trying to stop the dam and the water coming over. But that is not possible; it really isn't. So I do again thank you, very much, for holding this hearing.

With your indulgence, I would take you up on your offer of making this as much as a problem solving, issue illumination discussion as possible. So I would like to submit my full testimony for the record but really walk with you, or jog with you, through some of the key issues, and perhaps in so doing, I will try to reflect on some of the questions from your earlier panel.

When I first met with this committee a couple of years ago, we had another video, and that video, as I recollect, talked about some of the very, very dastardly, inexcusable conditions in assisted housing. Since that time, we have done a lot to deal with those conditions. We now have, where we didn't have 2 years ago, good information, not good enough, but good information, which is the study we have been talking about today.

We are now using modern technology information on a host of activities and projects. We at that time were talking about an audit that indicated that, of the total $40-plus billion of insurance in force under our multifamily programs, when we started this venture 3 years ago, the loan loss reserve that auditors require us to set aside was $11.9 billion, 27 percent of that total insurance.

Over the last 3 years, we have chipped away at that. In the recent audit, the loan loss reserve is now down to $8.4 billion—still too much. It is still a tremendous exposure, not so much to HUD, not so much to the Congress, but to the American taxpayer that we are all trying to work for.

We have also made a dent, I believe, in the inventory of properties and problems that we came upon. Over the last 2 years, we have sold almost 1,000 multifamily notes that had previously been delinquent and in default. Not only have we garnered proceeds, but, more significantly, as I recollect, the estimated net proceeds to the taxpayer—that is net above and beyond book value—is around

$600 million, which I think is also illuminating of the value that can be captured if the Government had less of a role sometimes as opposed to more of a role. I think there is a message in all of that.

Over the course of the last year, we have been involved with partners in different ways of doing business. While it may be useful and illuminating for us to look back and talk about how we got to where we got—and I will talk about that in a moment or two—it is probably more useful to understand, we don't do things that way anymore, which is good.

That doesn't, however, allow us therefore to walk away and deny the problems that have accumulated over time. Indeed, while it is easy in hindsight to say, "What could they possibly have had in mind? How could they possibly have provided 40-year mortgages with only a 20-year subsidy commitment?" one would think, "How would they do that? What did they possibly have in mind when they developed the financing system that provided all the incentives to produce and very, very few incentives to manage?"

It is easy to look back. But as some of us recall those days of the seventies or eighties, or our forefathers recall those days, in the seventies and eighties we were dealing with a situation where there was an appropriate and understandable eagerness to develop housing for people in need, and the commitment at the time that we ought to do all that we can to produce this housing, to produce it when the market would not produce it, and to produce it in a way that would maintain affordability over time. So that is what we did.

Anyway, let's talk a bit about where we are today and where we might go. As I said before, when this housing was produced, there were essentially three forms of assistance that were provided. Unfortunately, as the underwriting, as the assessment of that assistance, took place over time, they weren't always linked and looked to as a whole.

One element of assistance was subsidies. There were guaranteed subsidy contracts. The subsidy levels were set at an amount necessary to secure and underwrite a mortgage. That mortgage was then insured by the Federal Government.

We often had a situation where the mortgage, unlike conventional mortgages at the time, often was equal to the total development costs. In conventional financing, as you know, developers were required to put in a substantial equity involvement, particularly in these kinds of commercial ventures. But for purposes of this HUD program, it was not uncommon to have all the development costs secured by this mortgage. On top of the subsidies, on top of the insurance, there were very generous tax incentives.

The only correction, if I could, Mr. Chairman, in terms of your earlier comment, is, you just got the wrong name of the tax program. You are absolutely right, these were tax incentives. These, however, were before the low-income housing tax credit; these were in the days of pre-tax reform. There was accelerated depreciation and a whole host of other incentives.

Ironically and regrettably, those incentives provided motivation to increase the costs and increase the mortgage, because the tax return, the tax yield, was a function of the eligible basis. The higher the basis, the more that could be depreciated. So it was in everybody's incentive, except the taxpayers, over time, to increase the costs in the beginning.

As my colleague from GAO indicated, I imply no malice aforethought of those who are participating. As you yourself pointed out, those were the rules. That is what the rules were. People played by the rules. They developed these developments over time. But now the clock has moved, and now we are at a different stage.

Let's talk a little bit about where we are precisely today. As the data indicates, we now have a situation where approximately 850,000 units in approximately 8,500 projects. They face a situation where they are both insured by the Federal Housing Administration and also receive rental subsidies.

That, in logical terms, is not necessarily bad, except for the disconnects. The disconnects are really of two types: No. 1, there is a disconnect in the terms of the two contracts.

If indeed, when these developments were originally financed, if we had allocated sufficient funds for subsidy contracts that were exactly coincidental with the mortgage terms, then the situation that we now come upon, which is the subsidy contracts are expiring but the insurance goes on, would not pose a financial risk to the taxpayer. There would be other costs in terms of impact on residents and where they live, which we will talk more about, but you would not have the financial impact in terms of the insurance fund, because we now have a situation where the subsidy contracts expire, and yet the Federal Government over time is often put in a position that, if we do not renew those subsidy contracts, then we pay an insurance claim.

In other words, we have to pay more so we do not pay even more. I wish I had a clearer way of saying it, but that is essentially what it is.

The second issue is, in part because of the way these developments were capitalized at the outset, as our data indicates, about two-thirds of the subsidy contracts are over market.

Again, to put it in simple terms, the Government is paying more for a housing unit than anyone else is paying. That is what "over market" means.

Now, over the next 4 or 5 years, these contracts begin to expire. I appreciate the reference to our efforts over the last 2 years to bring this matter to everyone's attention. I appreciate that. I wish, certainly looking back over these last 2 years, that we had been more persuasive. I do believe that at least today there is a common agreement on the point you concluded on, which is, the one thing we know for sure is, the status quo is not sustainable.

In an era where there is a common and organized focus on deficit reduction and balancing the budget, the kinds of subsidies that would be necessary to sustain the status quo, very few people—there are a few, but very few people believe that is possible.

The difficulty, however, is what to do about it. Again, as I would again confess once again, for the second time, our proposal has not carried the day in terms of how to go about this change.

I think there is agreement that change is necessary. We believe there are certain principles, however, that are worth noting in any proposal, because the one alternative that we find absolutely unacceptable and unsustainable is the status quo.

Principle No. 1 is that we ought to ensure that we take on this task of, and I don't want to use jargon, but restructuring the financial terms of these developments in a way that would be sustainable on a proactive basis. That is to say, if we wait for defaults, if we wait for contracts to expire and for subsidies to cease, there will be an inevitable disinvestment in the properties. The real losers will be the residents and the neighborhoods in which these properties are located.

So principle No. 1 is, we ought to do this; unlike other problems the Government gets involved in, do it on a proactive basis as opposed to a reactive basis.

Principle No. 2 is, we ought to concede that in the future, going forward, if we want to motivate behavior by the private sector—and, as an aside, I agree with you, there is a different play on this with nonprofit/for profit, but if we want to motivate behavior by the private sector, let us, to the extent we can, use the market as a motivator; let us not continue to fight the market.

We clearly understand that the old way of regulation, the old way of intensive staff overview and oversight, is also not sustainable. While we may say here, as I did 2 years ago, that we don't have enough staff or enough capable staff to oversee these projects, let me say to you, Mr. Chairman, 2 years later, we have less today.

There is an inevitable downsizing of the Government which has very little to do with this particular issue, but it is a reality of the political environment we are all in, and we understand that reality.

The third principle, which relates to the second principle, is, as we proceed on this restructuring, I would be misleading you if I said that today or tomorrow or the day after tomorrow that we at the Department have the capacity to individually restructure 8,500 different projects. We need assistance, but we need, I think, a special kind of assistance, not assistance of contractors, though clearly we use contractors and we will keep using contractors, but we need the assistance of partners. Referring to my second principle, I would suggest in selecting those partners, that the best way to motivate those partners is to ensure that they have a stake in the outcome of the restructuring. We believe they are excellent candidates for that.

Mr. SHAYS. I am missing the third one. There is a principle, you can't wait for defaults. You have to let the marketplace be the motivator. Now you get into detail. What is the principle behind the detail?

Mr. RETSINAS. The principle is that HUD does not have the capacity, and the principle is that a partnering approach is the only way to move this agenda forward.

We believe there are good candidates for partnering. We believe the work of the State housing finance agencies can shed some light on this. We have partnered with them in a variety of programs over the past couple of years. We would not limit it to them, but we would look to public sector organizations to the extent we can.

And the fourth principle and last principle, before I conclude with some operational points that I would strongly urge, and it may seem obvious, but I have been here too long not to say the obvious sometimes: We do not believe, notwithstanding the immense proportion of the budget crisis, that we ought to abrogate existing contracts. That is, existing contracts, while they may be oversubsidized, ought to go on.

I add parenthetically by the way, we have no statutory authority to reduce contracts that are above market.

Let me close, if I could, and I apologize for sort of walking through it, but I want to give you a sense of both the frustration and the eagerness I have for this challenge. Let me talk about the three or four issues that provoke the most debate in our proposals and not sit here and advocate a particular approach, but let me tell you what some of the pros and cons are of a couple of the issues.

Issue No. 1: If you were to restructure, what ought the rent to be? What is the right rent to pay?

Our proposal argues strongly that the right rent to pay is the market rent, that we ought to pay what the marketplace pays. That is the best way to reduce the unnecessary exposure and cost to the Federal Government.

We have had many criticisms about that proposal, because people argue, well, how do you know what the market is? In some places the notion of market doesn't make much sense, because you don't have comparables. There are alternatives.

One alternative is to just say, just by fiat, well, this is what the rent will be; set a formula.

We have reservations about that approach because a formula, almost by definition, sometimes will be too high and sometimes will be too low. Indeed, it will not, again, put that focus on the market that we think is appropriate.

There are others suggesting that the rent ought to be what they call budget-based. That is whatever a project needs. And, again, we question, one, our capacity to administer a true individual budget-based approach and, second, whether in fact that it moves away from what we think is an appropriate understanding of tenants and residents as customers, not as victims of this effort.

Mr. SHAYS. I want to have you go through those two real quickly with me again. You say you would set the rent based on what, the first one?

Mr. RETSINAS. We would prefer the rent be set on the basis of what the market is.

Mr. SHAYS. And the second was based on what we have the ability to pay?

Mr. RETSINAS. The second approach that some have suggested is just to set a formula. For example, one approach is, well, the rent should be a certain percentage of fair market rent; a rent ought to be at a certain number. Just by formula, by fiat, set a particular number.

The third approach is what is called budget-based. That is, the rent ought to be whatever the project needs it to be.

The difficulty with the third approach is, if one of your conditions is to not have defaults, then you would have to set the rent at a high enough level, albeit inflated, so that the existing debt service payments can be made.

So we think those are basically the three alternatives on rent setting.

Mr. SHAYS. OK.

Mr. RETSINAS. No. 2, which I have alluded to before, is the use of third parties. I will not go over it in detail except to say you have what I think are three basic options:

First, HUD doing it; and I have already questioned our capacity to do so, as others have, including yourself. The second is the use of contractors, which, again, has implications for the Department is a capacity to manage that process. And the third, which we favor, is the use of a third party or partners, partners, again, who would have a stake in the successful restructuring.

Mr. SHAYS. Can you just elaborate a little bit? When you say a stake, what kind of a stake?

Mr. RETSINAS. It seems to me that, again, to motivate behavior, people ought to be rewarded if they do well and not rewarded if they do poorly.

So, for example, right now, for the last 3 years, as we write new FHA insurance in a number of States, we do it through a program called risk sharing, which was authorized by the Congress 4 years ago. In that particular program, we delegate to a State housing finance agency—there are a couple of local agencies, but generally a State housing finance agency, the ability to endorse a new project for insurance.

With that authority, however, they must share the risk. So if at some future date that project fails, at some future date a claim must be paid, at some future date there is a loss because the recovered amount, is less than the outstanding insurance, then the way this program works, we, the Federal Government, and the State share the loss. That is what risk sharing is all about.

We think that is a model that works, and, again, we think it is a model that appropriately motivates the right behavior.

I generally find when people have something at stake, they are more likely to act in my interests than if they don't.

The third area that we want to speak to is the issue of FHA insurance. Again, as in the other areas, we believe there are three options.

Option No. 1 is, under no circumstances provide any FHA insurance; once you do the restructuring, just end the FHA insurance.

Option No. 2 is to automatically continue the FHA insurance.

Option No. 3 is, allow the new projects to apply for FHA insurance, but under today's rules, not yesterday's rules.

We believe the first case—absolutely no FHA insurance—would sometime deny financing for projects that because of their location or situations, the private sector alone just will not get involved in.

The second option—automatically continue the FHA insurance—we believe is just a continuation of the problem that got us into trouble in the first place.

The third option is the one we prefer, which is using today's rules, such as risk sharing; as an example, allow projects as they become restructured, to apply for refinancing under the current guidelines or rules of the FHA insurance program.

Let me just conclude by saying, in a sense, as big as the problem is, it is relatively straightforward, as I suggested. We as a Government, we as taxpayers, are artificially subsidizing properties, and we are forced because of the financial arrangements to do so to save even greater costs. We all agree that something must be done.

Over the past year, we and the Congress—again, this is together—we have put our foot in the water. As you indicated, with the passage of the fiscal year 1996 appropriations bill in late April of this year, we were given demonstration authority for a select number of units with a select amount of money.

That authority, that demonstration program, is now underway. The guidelines were published in the Federal Register the first week in July. Our first loan committee meeting on transactions is next week.

However, Mr. Chairman, again, I want to be—in respect for your candor, also be honest with you. To really observe that demonstration, to really truly assess that demonstration, we are going to need 2 or 3 years, because we will not know whether this worked until time passes.

We could certainly determine whether or not we restructured projects but to determine whether we restructured in the right way, you need time to pass for loans to mature. I do not believe we can wait. I believe it is absolutely critical that we address this issue. Even though the mountain is a very high one, we need to begin scaling it.

Mr. SHAYS. Twenty-five percent will come due next year; correct?

Mr. RETSINAS. About 230,000 units come due next year. Only about one-third of those are above market.

Mr. Chairman, that concludes my statement. I would be obviously more than happy to answer any questions.

[The prepared statement of Mr. Retsinas follows:]

STATEMENT BEFORE THE

HOUSE GOVERNMENT REFORM AND OVERSIGHT COMMITTEE

SUBCOMMITTEE ON
HUMAN RESOURCES AND INTERGOVERNMENTAL RELATIONS

BY
NICOLAS RETSINAS
ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISSIONER

WASHINGTON, DC
July 30, 1996

INTRODUCTION

Thank you Chairman Shays and Members of the Committee for this opportunity to testify on the impending crisis facing the nation's stock of federally assisted, privately owned housing -- and the Administration's proposal for addressing the crisis through portfolio reengineering. The crisis affects 8,500 properties -- about 850,000 units that both receive Section 8 subsidy and have mortgages insured by the Federal Housing Administration (FHA).

Mr. Chairman, it is important to note for the record that you, and this Subcommittee, have played a significant role in identifying long-standing problems with the multifamily assisted housing programs. This Subcommittee held a series of hearings in 1994 on the cost, quality and effectiveness of the multifamily housing subsidized stock. Testimony from the General Accounting Office, HUD's Office of Inspector General and others graphically demonstrated that the escalation of rents and the deterioration of the housing units were contributing to a crisis situation. There was no doubt that HUD policy makers and staff were faced with major operational and programmatic challenges.

Looking back on those days I can say with all honesty that those hearings provided a good deal of impetus for the actions that we took to improve the quality of data, enforcement activities, and portfolio management. Chairman Shays, thank you for those strong efforts and I would like to preface my remarks about the portfolio reengineering concepts by explaining some of the improvements your hearings have fostered.

Improved Portfolio Management

Major improvements have been made in portfolio management and analysis. This can be measured in both financial terms and operational terms. For example:

-- FHA will have a pilot data warehouse by this September that provides better opportunities for field office staff to analyze their portfolios and to better service the loans.

-- FHA for the first time in history conducted an internal loan loss reserve analysis by risk ranking over 12,000 individual projects.

-- The loan loss reserve itself has decreased substantially over the past three years from $10.3 billion in 1993 to $8.4 in 1995.

-- Thirteen training courses have been conducted for over 2,000 multifamily housing staff on asset management activities.

-- Field managers were empowered to make decisions at the lowest possible level and matrix organizations were formed to "work share" as a means of overcoming staff shortages and imbalances.

Asset Sales

In order to aggressively reduce the large portfolio of Secretary-held mortgages (defaulted mortgages), FHA has established a core team of employees and contractors that use creative and innovative business tools to carry out a highly effective loan sales program. Examples include:

-- Multifamily notes have been sold through a program of mortgage sales. From 1994 to 1996, HUD sold 927 loans with an unpaid principal balance of $2.8 billion, thus reducing asset managers' dangerously high workloads. Further, the loan sales generated over $2.1 billion in gross proceeds to the taxpayers, $714 million higher than the value of the loans had HUD continued to manage them as in the past.

-- Included in the mortgage sales program was a June 1996 structured finance transaction involving 158 loans with an unpaid principal balance of $885 million. The projects represented by these loans included approximately 6,400 units of subsidized housing. This sale resulted in $645 million in proceeds to the taxpayer.

Improved Tenant Involvement

More important than the financial and operational matters is the increased attention being paid to investing in residents as customers, thereby increasing the value of properties and communities. FHA has taken several initiatives to improve tenant satisfaction. Some examples are:

-- A Neighborhood Networks initiative that encourages owners to invest in computerized learning centers has resulted in some 40 projects becoming operational and another 400 projects in various stages of completion within seven months of the initiative's inception. Education and job training are the focus of these centers.

-- FHA has endorsed and sponsored the use of VISTA volunteers to work with tenant organizations in bettering the living conditions at projects.

-- HUD's FHA staff interact continually with tenant groups at local and national levels as a means of ensuring that tenants have a voice in housing programs.

Improved Enforcement Activities

Significant steps have been taken to upgrade the use of enforcement tools and to develop new ones, including the following measures:

-- FHA established a Special Workout and Assistance Team (SWAT) to serve as both an enforcement arm and a training vehicle. The SWAT team has been an active partner with owners in turning projects around and a strong adversary to owners when appropriate in taking needed sanctions.

-- Since its inception in 1994, SWAT has screened over 880 projects, has assigned over 400 of those for comprehensive review and action, and has completed reviews on 256 projects. Of those 256 projects, owners came into compliance on 163, Departmental sanctions were taken on 51 projects and 42 projects required no actions.

-- In addition to the SWAT activities, enforcement throughout the system has been emphasized and increased. In 1994 and 1995 enforcement actions at FHA were at a record high, especially in the areas of required changes in management agents and in the use of foreclosure tools.

-- Legal services contracts were recently initiated to complement the services provided by the short-staffed Office of General Counsel. Contractors are currently working on sanction activities on 16 projects.

-- During 1995 and 1996, the Administration submitted legislative proposals to Congress to further strengthen enforcement. No action has been taken to date on the proposed legislation. One of HUD's key proposals was a request for legislative relief from the bankruptcy protections afforded to multifamily project owners. The use of this protection has been one of the major impediments to swift and effective enforcement action.

Mr. Chairman, we have come a long way since this Subcommittee's hearings in 1994. It goes without saying that much more needs to be done to arrest the problems. But we are proud of our accomplishments and we are especially pleased that three of the initiatives I mentioned above were recently recognized by Vice President Gore's National Performance Review Hammer Awards -- namely Asset Sales, SWAT and Neighborhood Networks.

It is also important to note that, as HUD, under the leadership of Secretary Cisneros, came to grips with these problems and began to analyze the conditions and causes of the current situation, it became abundantly clear that major initiatives and policy shifts were the only long-term solution. Hence, the move towards our current proposals to reengineer the financing structure and, more importantly, treat housing as a valuable resource for building better neighborhoods by investing in the people that reside in the projects.

THE NEED FOR PORTFOLIO REENGINEERING

HUD has put forward a proposal to reduce Section 8 subsidized rents to market while simultaneously reducing the FHA-insured debt to a level that can be supported by market rents and would help pay for necessary repairs to these buildings. I welcome your leadership and commitment to address this critical issue.

The vast majority of the residents of these properties are low-income, and a substantial proportion are elderly. How we manage the transition of this portfolio going forward has critical long-term implications for millions of residents and hundreds of communities.

The context is not bricks and mortar or expiring contracts or government rules and regulations. The context is people and neighborhoods. I believe we have a unique opportunity to reengineer this portfolio and the programs underlying it. We have an opportunity to rebuild declining neighborhoods and inner cities through our investment in a reengineered housing system.

We also have the opportunity to see housing and its growing costs as a critical piece of the "solution" rather than as a "problem." The rapid growth of our own Neighborhood Networks initiative -- where we encourage computer learning and job centers in subsidized buildings -- suggests to me without a doubt that the seeds of a new and better approach are growing.

Some Progress but Fundamental Problems Remain

I can report to you that working together over the past 18 months, Congress and the Administration were able to undertake important interim measures to begin to address the Section 8 crisis.

-- We acknowledged that the status quo and paying above market rents for assisted housing is no longer sustainable.

-- We gathered updated data about the Section 8 portfolio -- including the composition of the portfolio, the rent levels, and the condition of the properties.

-- We initiated a broad debate to address the problems -- involving virtually all of the constituencies that are affected by changes in the Section 8 assistance program.

-- We have begun to implement a Congressionally authorized demonstration program to test a number of different approaches.

Despite our progress, however, we have still not solved the fundamental problem. It is critical that we confront this problem now by passing legislation that will help us preserve affordable housing resources over the long run. The longer we wait, the more difficult it will be budgetarily and administratively. The basic question, which was posed by Peter Passell in the New York Times on July 18, is whether Washington (and the American taxpayer) "will end up paying a little now or a lot more later." Mr. Chairman, I would ask that a copy of that article be included with my statement for the record.

History of Over-Subsidization

To fully understand the need for portfolio reengineering, it is necessary to understand how much of our multifamily inventory came to be over-subsidized.

From 1965 to 1983 the Federal government through HUD and the Internal Revenue Code subsidized the development of privately-owned multifamily apartments by providing low-interest loans; insuring mortgages made by private lenders; furnishing project-based Section 8 subsidies to pay rents; and providing tax incentives by allowing rapid depreciation on properties financed with non-recourse debt

This system of assistance produced substantial amounts of multifamily housing but, in recent years, it has suffered serious and growing problems, chiefly due to insulation of the properties from market forces. Thus HUD, at this point, is paying rents far in excess of the market rents paid by unsubsidized tenants. Moreover, HUD is paying these excess rents for about two-thirds of the reengineering portfolio.

Let me give you some examples from a General Accounting Office investigation of this issue:

-- Here in Washington, DC, the GAO discovered that the Federal government pays $734 a month in rent for a subsidized Section 8 apartment, when rent in a comparable unit in a neighboring, unsubsidized building is $500.

-- In New York City, the government pays $1,138 a month for subsidized apartments, while the monthly rent for units in neighboring unsubsidized buildings is $600 or $750.

-- In Las Vegas, the same pattern is repeated: $820 a month for Section 8 subsidized units -- and comparable market units renting at $380.

-- In Chicago, the government pays $849 a month for apartments in a subsidized Section 8 building, while landlords in comparable unsubsidized units charge $435 to $475 as market rents.

The other one-third of our portfolio of properties are under-subsidized and most have fallen into distressed condition, with owners having no financial incentive to put more funding into these projects. Tenants are effectively trapped. If they try to move, they lose their federal rental assistance because the subsidies are tied to the building.

Budgetary Issues

Beginning in FY 1997 -- and for the next 7 years thereafter -- Section 8 contracts will expire on 850,000 units of FHA-insured housing. The majority of Section 8 contracts on the 8,500 properties expire by 1999. These expirations include a very large wave in FY 1997 -- 236,000. Earlier this year, as an interim measure, Congress agreed to extend contracts expiring in 1996 for one year at current rents.

Downward budgetary pressure on discretionary spending means that the Federal government can no longer sustain the large and growing costs of renewing over-subsidized Section 8 contracts at their current rent levels. The cost of renewing Section 8 project-based assistance will increase from $950 million in fiscal year 1997 to almost $6 billion in fiscal year 2002. We do not anticipate Congressional funding for HUD's future-year budgets that would allow continued payment of Section 8 rents at their current levels into the future or to bolster subsidies for troubled projects.

Given continued Congressional pressure to reduce HUD's budget, the Administration believes that the prudent course is to use the market to set rents and make a corresponding write-down of debt on these buildings in a managed, orderly fashion.

Operational and Policy Issues

We must responsibly address the crisis caused by expiring Section 8 contracts. The only way to responsibly address the impending crisis is to change the process by which HUD supports these apartment buildings. In so doing, we must protect residents, communities, legitimate interests of owners and taxpayers. What we are looking for is a fair and equitable way to address a very complex problem.

While the Section 8 program is complicated, the choices confronting us are stark and action is needed soon. We cannot afford to renew contracts that are above market at their current levels. If we do not renew all of those contracts at their current over-subsidized rents, or financially restructure these properties, most owners will default on their FHA-insured mortgages. The result will be massive claims on the FHA fund -- possibly up to $2 billion in claims for the 1997 expirations alone. Furthermore, many properties with below-market subsidies have significant capital backlogs. The needs of these properties must be addressed as well.

But there is more than a financial cost to massive defaults. There is also a very real human and community toll. Defaulting on a mortgage does not happen suddenly. It is a process that can be stretched out over years as owners seek refuge in bankruptcy court or use other means to delay the inevitable where they lose their properties and must recognize as taxable income the debt as if it were the proceeds of the sale.

As the owners default, they pull resources out of their apartment buildings. They stop making repairs because they have no financial incentive to do so. We have seen this pattern time and time again. The residents of these apartment buildings suffer as the quality of their units deteriorate -- sometimes to the point where HUD is forced to take over the building. Meanwhile, the surrounding neighborhood feels the impact of another apartment building that is being abandoned by its owner.

From a policy perspective, it is difficult to justify the continuation of over-market rents. They began 20 years ago to induce the private sector to build in areas where they would not otherwise have built. But should we continue to pay in excess of market rents to induce the private sector to continue owning or operating these units?

From a budget perspective, over-market rents cost too much. In FY 1997 alone, the federal government will spend an additional $150 million to keep these rents above market, and this amount grows in the out years. This not only drains scarce federal housing resources, it also weakens public support for affordable housing programs across the board.

ADMINISTRATION'S PROPOSAL

We believe the solution to the problem of over-market rents is straightforward:

1. Reduce over-market Section 8 rents to market levels and introduce the discipline of competition in the operation of the properties.

2. At the same time, reduce the amount of the mortgage on the building to a level that can be supported by market rents.

3. Provide appropriate solutions for the tax issues confronting the owners of the property as a result of restructuring -- that is, cancellation of debt gives rise to taxable income in the amount of the debt forgiven.

Carrying out this process is not simple, but we believe that the best way to serve the interests of everyone -- the taxpayers, tenants and owners -- is to use the forces of the marketplace.

Analysis of the Portfolio

To help us understand what needs to be done and to answer questions about the portfolio and the impact of restructuring, HUD engaged the E&Y Kenneth Leventhal Real Estate Group to carry out an analysis of the FHA-insured, subsidized portfolio. Here is what we learned from the EY study:

<u>Size of Portfolio</u>

-- There are 8,563 properties, 708,273 assisted units, 142,762 unassisted units and $17.8 billion of mortgage insurance at risk in the reengineering portfolio.

<u>Problem is serious</u>

-- 63 percent have rents greater than market rents

-- 37 percent have rents less than market rents

Physical condition of properties

-- There are short term maintenance and capital needs across the entire Section 8 insured portfolio averaging $6,400 per unit.

Portfolio reengineering can solve the problem

-- Three-fourths of the portfolio works in market conditions after restructuring.

-- 13 percent of the properties require additional capital support to pay for repairs.

-- An additional 13 percent do not work in normal economic terms and present a special challenge.

One size does not fit all

-- This portfolio has many needs and resolving the problems of this portfolio cannot be accomplished by applying a single formula across the board. It will require a variety of tools. We should not construct a solution for all based on the needs of 13 percent of the portfolio.

Overarching Principles

The Administration's proposal is based on the following principles:

* Residents and neighborhoods must be protected.

* Portfolio reengineering must be undertaken in a way that recognizes the diversity of the portfolio and owners.

* The interests of the taxpayers must be protected through proactive and efficient implementation.

* There will be no abrogation of contracts.

* Any solution must recognize the limitations of HUD's current and future staffing resources.

* For 1997, we should focus on projects with rents above market while continuing to develop a strategy to address other severe capital needs in properties below market.

Costs Savings

The Administration estimates $0.9 billion in mandatory savings and $1.8 billion in discretionary Section 8 savings were estimated for the period 1997-2002 under the portfolio reengineering proposal. In discussions with Congressional Budget Office staff, we understand that CBO may have reached a different conclusion about the mandatory savings from portfolio reengineering. These differences appear to be based upon different assumptions about recovery rates or, in other words, levels of payments to reduce mortgages and the benefits of providing owners with an option to restructure before contract expiration (known as proactivity).

We believe that the new data from the E&Y/Kenneth Leventhal analysis, which was not completed when CBO prepared their scoring earlier this year, will lead to different assumptions about recovery rates. We look forward to further discussions with CBO on this matter.

We also have refined our analysis since the President's budget was submitted. In addition, the Administration's proposal has also been refined between February and now; therefore, our estimates will change, too. In developing the budget for fiscal year 1998, we will adjust our estimates based on new information regarding claims costs and recovery rates.

HUD's Capacity

We have stated earlier that HUD alone does not have the capacity to achieve portfolio reengineering or to individually negotiate with 8,500 lenders and owners or restructure 850,000 units housing. In fact, that could be said for any one entity, including the RTC in its heyday or Fannie Mae today. To reengineer this portfolio, a combination of the following skills and expertise is needed:

-- historical knowledge and program expertise;

-- clear direction and defined structures and roles suited to reengineering properties, tenants and mortgages simultaneously;

-- capital to pay claims and refinance debt;

-- bankruptcy, tax expertise, other legal and real estate expertise;

-- extensive troubled workout experience;

-- community linkage; and

-- capacity to work with residents and define services.

HUD has the ability to successfully monitor portfolio reengineering if the partnerships are:

-- structured so that the partners are motivated to perform and not just **regulated** to perform;

-- the standards for performance and definition of success are clearly defined and address public purpose issues, such as the condition of the property, accommodations for residents and owners, the community's role and pricing;

-- the partnership has comprehensive experience in the areas I outlined above; and

-- the monitoring is proactive and based on clear benchmarks.

HUD has been successful in attracting quality partnerships, defining clear roles, sharing expertise and obtaining good results. This is exemplified both in the risk sharing and mortgage sales programs. Those efforts have effectively shared risk and profits, defined the end product and demonstrated HUD's ability to monitor complex public-private partnerships.

The mortgage sales program has enabled FHA to develop and demonstrate joint venture partnerships. In the partially assisted sale, which netted $200 million in credit reform value and produced a 72 percent return, FHA designed, developed, and implemented a sophisticated transaction that incorporated in-house monitoring. In the multifamily risk sharing program, we have over 30 public and private partners jointly delivering almost 15,000 units to date of insurance authority. While the program is only two years old, it has operated smoothly.

ALTERNATIVE OPTIONS AND CHOICES

Four critical issues have been the subject of considerable debate and discussion in trying to arrive at a fair and workable approach to portfolio reengineering: how rents are set, the role of third parties, the availability of FHA insurance, and tax problems confronting owners.

These issues deserve special attention here because they involve how much the government pays and when, how much compensation parties to the process receive, and the long-term future of FHA. The choices facing us in each of these areas is a continuum ranging from market-based solutions to more government-imposed solutions.

How Rents Are Set

The choices insofar as rents are concerned essentially comes down to three choices:

- -- market-determined rents, which the Administration is proposing;
- -- formula-based rents based on the HUD-determined Fair Market Rent (FMR) for the area; and
- -- budget-based rents based on the owner's budget for the project, subject to a reasonableness test.

We are concerned that our ability to regulate rents, whether by a formula or on a budget basis, leads to distortions in rent levels. In addition, if rents are regulated, there is no incentive for management to see tenants as customers or to offer creative cost-cutting solutions that deliver the best value to the taxpayers. In addition, no private lender will finance regulated rents given that contracts are now subject to annual renewals. These short-term contracts would make FHA-insured loans the only viable option for reengineered properties.

Choosing a half-way solution -- renewing all above-market contracts at market levels but not providing any portfolio reengineering tools -- would also have grave consequences. This option would be like choosing one form of poison over another. We would be triggering massive defaults, disrupting the situation of owners and tenants alike -- a move that would, in my judgment, be irresponsible. We estimate that 83,000 units that expire in FY 1997 have rents above market. If those units are renewed at market rents, HUD estimates that FHA could have to pay as much as $2 billion in claims on defaulted mortgages. These defaults would happen in an unstructured manner with no protections for residents or communities.

Third Parties

The options regarding third parties, again on a continuum, are as follows:

- -- No use of third parties and simply allow the mortgages to be managed by HUD staff;
- -- Public or private contractors who would administer the restructuring process for a fee;
- -- Entities who would put up capital and take risks in return for monetary rewards when the restructuring process succeeds beyond some predetermined benchmark; and

-- Sale of the secretary's rights and remedies to a third party.

To deny HUD with its limited staffing and capacity the use of third parties will perpetuate the protracted and ineffective resolutions of problem loans and properties that was the thrust of my testimony two years ago. Since then we have demonstrated through the loan sales program and the pending sale of mortgages to HFA's that HUD can utilize third parties effectively while preserving the public interest as long as the third parties have proper incentives.

FHA Insurance

The choices to be made regarding the presence or absence of FHA insurance include:

-- No FHA insurance

-- Interim FHA insurance to assist in the transition to market

-- Full FHA insurance

While there might be a role for the FHA to facilitate the transition of the properties to market, to mandate that FHA insurance remain in place after payment of a partial claim to the lender could lead to a repetition of HUD workouts that leave HUD vulnerable to excessive "echo" claims in the future. We believe a more prudent approach would be to allow project owners to apply for FHA mortgage insurance on a <u>new</u> mortgage.

Tax Solutions

A fourth area that requires attention is that of tax solutions. Some proposals have relied on bifurcation of the project debt into performing and non-performing parts in an attempt to avoid tax consequences of debt restructuring for owners. We are concerned with this approach because the second mortgage could accrue interest at the applicable federal rate for up to 40 years and would be required to be repaid after the first mortgage is repaid. This accruing second mortgage could quickly consume all of the project's equity. Specifically, this could occur if the cash flow from the property is too small to support both mortgages layered onto the property. The owner could have no financial incentive to maintain the property, exposing the taxpayers and residents to the dangers of severely dilapidated properties with no owner incentive to maintain them.

A bifurcation of the project debt could also add to the cost of any portfolio reengineering proposal because the second mortgage could be scored as a loan modification that would use appropriated credit subsidy, with a very high subsidy rate, perhaps even 100 percent.

The Administration is willing to discuss with Congress mechanisms to take account of the consequences relative to debt forgiveness for property owners who enter into restructuring agreements with HUD.

Responses to Administration's Proposal

Some owners have expressed concern or opposition to the Administration's proposal for a variety of reasons, including: (1) the use of third parties; (2) how rents are set; and (3) the absence or presence of FHA insurance. I believe, Mr. Chairman, that opposition to the Administration's proposal comes down to two primary factors. One is the fact that many owners simply want to continue being insulated from market forces by receiving subsidies and they do not wish to take their chances with a third party charged with striking the best deal for the American taxpayers.

If I may digress for a moment, Mr. Chairman, I am pleased to note that you have chosen as a witness today an owner that has not had an active voice in this process -- the American Association of Homes and Services for the Aging -- an owner that has done a good job overall in maintaining their properties. A large part of our portfolio, it should be noted, serves the elderly.

There is some tension for non-profit owners in a destabilizing environment such as we are in today, but change does not pose that great a threat to these owners, either. We strongly believe that competent non-profit owners must and will be protected. These are the types of organizations we hope to work with in the future to craft solutions for an enduring stock of affordable housing. We are very interested in understanding their needs and the contributions they can make.

CONCLUSION

In concluding my remarks, Mr. Chairman, I would simply emphasize that the Administration continues to believe that the best option is to begin the process of portfolio reengineering in FY 1997 by focusing on properties that have rents that are over market. We look forward to discussing with you and this subcommittee ways in which to implement portfolio reengineering.

Mr. Chairman, we appreciate your leadership and urge that, together, we send a message today to the housing community:

-- a message that says the status quo cannot win the day, and we cannot defer action another year.

-- A message that says we must find a better way to house residents and earn the trust of the taxpayers.

-- A message that says we cannot renew at current rents another year and hope for action when more information is available.

Mr. SHAYS. Very interesting testimony. Thank you.

Ms. Gaffney.

Ms. GAFFNEY. Thank you, Mr. Chairman.

I want to talk primarily about HUD's institutional capability, because it bears on the way we are going to have to go at this. But I would like to start by just saying, you know, it was really this subcommittee that brought a focus to this whole issue.

I think if you look back over the past 2 years, something monumental has happened, as Nick said, and that is, finally everybody agrees we are just paying way too much for this housing.

The problem I see is that we have gotten that far and we don't seem to be getting further. The way the discussion is proceeding is not toward consensus. It seems almost to be moving in the other direction. I would say to you that if you can devise some other format for moving toward consensus, we would all benefit enormously.

There are two issues that people bring up in reaction to HUD's proposal that I would just like to mention. One is, people say we cannot afford to lose this stock of affordable housing.

I must say to you, I find that so unbelievable. This is not affordable housing; this is housing that is deeply subsidized by the U.S. Government. In terms of plain English, it seems to me there is a real big difference between those two ways of characterizing it.

The other issue that keeps surfacing is the usefulness, the viability, of these tenant-based vouchers. There are dramatically differing opinions, and I do not understand why we cannot move to some consensus on that issue based on some kind of data that we all could accept.

But absent that, we simply are in two camps. One camp says they are almost always useful and viable, and another camp says no, they aren't, and they are becoming increasingly less useful.

So those are my overall comments. Now I want to talk about HUD's institutional capabilities. Every time I do this, Nick Retsinas says I am playing into the hands of his opponents, and I really am not trying to do that. I am not trying to give HUD a hard time; I think it is important to be honest.

Mr. SHAYS. I missed the first part of that. I was trying to check with staff here. I missed the first part of what is useful and not useful. Therefore——

Ms. GAFFNEY. The tenant-based vouchers.

Mr. SHAYS. Thank you. That was just a key point I missed. I was trying to catch up to you. Thank you.

Continue.

Ms. GAFFNEY. So I am going to talk to you about HUD's institutional capability. Let me tell you again that Nick Retsinas always objects to my doing this, because he says it plays into the hands of his opponents who use HUD's weaknesses as an excuse to do nothing. That is not what I want to do here today.

I want you to understand the condition that HUD is in, in this area, so that when we devise solutions—many of which I think will be in the same direction Nick has proposed—they recognize our institutional capability.

Nick said that FHA has had a reduction in its loan loss reserves over the past couple of years. That is right. We think that is primarily because they have gotten better at doing the estimate. But, you know, they have also gotten an unqualified opinion on their financial statements over the last 3 or 4 years. That is the good news.

The bad news is that the accompanying reports on internal controls continue every year to report the same systemic material weaknesses. I am going to run through those with you. But I would also say to you, this is not new news. This is what the situation was that NAPA described a year or a year and a half ago as diminished institutional capability resulting from budget reductions.

Mr. SHAYS. Let me just say something. You can't be reluctant to talk about this. This is pretty basic stuff. The people that negotiate with you and so on know this. So it existed well before your time.

Ms. GAFFNEY. Yes.

Mr. SHAYS. So we are asking you to get better with less resources. So we just need to make this a matter of public record, and then we just figure out how to deal with it.

Ms. GAFFNEY. NAPA talked about HUD in terms of drastic budget reductions, increasing numbers of complex programs, and an unclear mission.

How this plays out in FHA, in the Office of Multifamily Housing, for instance, is that they do not have adequate data or data systems on the housing in this portfolio, or their other housing, as a matter of fact. We have an ongoing audit of that area.

They have tried over the last 20 years five times to build an integrated financial management system for the multifamily portfolio, and they have failed to carry through five times. So they are in a situation where they have systems that do not contain accurate data, systems that are incompatible, and systems that are not routinely used by the field staff.

When we surveyed the field staff about how they feel about their data systems, essentially it is all negative.

Now, that has resulted from a couple of reasons. One is, there really is a funding problem, and it is getting worse. There is also a lack of priority generally attached to management issues in HUD.

HUD is focused much more on big-picture kind of policy things than it is on the boring, day-to-day management tasks. And building data systems is a long-term, excruciating effort.

That is why the Ernst & Young study, you see, is so important, because this is the first time that we believe we have had reliable data about what is in this portfolio. You realize, we had to hire a contractor to go out and compile these data, because we could not trust our own data.

We, the OIG, have surveyed, tested, what Ernst & Young did, and we think they did a good job. They didn't use in many cases the HUD data, they went out and got the data firsthand themselves. At least we have data now we can use as a framework for moving forward.

The other thing Nick talked about is a data warehouse; that is, the office's current proposal for system integration.

Mr. SHAYS. The only person smiling in this room right now is Ernst & Young. Everybody looks so somber except them.

Ms. GAFFNEY. Their current proposal for dealing with their data problems is a data warehouse, which is essentially a means for taking the existing incompatible systems and making access to them seem less, as it were.

Our problem with that is, that is fine from a technical point of view, but our problem starts with the accuracy and completeness of the data. If you are not going to overcome that problem—and I am not aware of their plans to do that yet—the technical solution is not going to get us very far. So data systems are real big considerations as we go into this reengineering.

In terms of housekeeping, the Office of Multifamily Housing is a part of HUD. HUD has been the victim of relentless budget cuts, which continue. We now have a situation where our ratio of loans to servicers—in Baltimore, for instance, one loan servicer has responsibility for more than 100 loans.

Mr. SHAYS. Is this an office in Baltimore that has a national responsibility?

Ms. GAFFNEY. No. This is the office of multifamily housing——

Mr. ZELIFF. I didn't know it was located in Baltimore.

Ms. GAFFNEY. In Detroit each servicer in that office had responsibility for 105 loans. These loans tend to be more troubled than the equivalent loans in the private sector. To give you an idea, the State housing finance agencies generally have a ratio of 15 to 20 loans per servicer.

How can they possibly stay on top of that kind of a portfolio? This is a personal observation. When I have gone to those offices and talked with those people, they are paralyzed. They are paralyzed by the magnitude of the workload that they can't keep up with and even if they wanted to go look at the projects, they don't have travel funds to do that.

I will repeat one statement from the Price Waterhouse audit of the 1995 financial statements. "Resource restrictions that increase the risk of borrower default and/or the cost of servicing and disposing of assets are fundamentally at odds with proper credit management and actuarial soundness." And that is the situation we have right now with the multifamily portfolio.

The mortgage sales are a step forward in trying to better manage the workload, but at the rate we are going, they are surely not a solution.

The last thing I would like to talk to you about is the institutional culture at HUD. What HUD traditionally likes to do is production; new programs, new grants, new insurance, more, because that is positive and people like that. What HUD traditionally does not like to do is management and enforcement. The OIG has been engaged in a discussion with FHA and NIC and the Secretary over the last year about the need to try to streamline HUD programs—not because we are opposed to HUD programs, but because HUD's resources are being cut back so dramatically that at some point if we want to have any stewardship over the funds that are being expended we are going to have to streamline.

We recommended streamlining by eliminating HUD insurance of hospitals, nursing homes, multifamily housing in general, mobile homes, and property improvement loans. We didn't say those things weren't useful, just marginal to HUD's basic mission. For various reasons, HUD wants to hang on to those programs because they view them as essential for housing and for communities.

Another part of the HUD culture is an unwillingness to take enforcement actions. What I mean by that is when these mortgages are insured, the owners enter into regulatory agreements with us. They are required by the regulatory agreements to put money back into the projects to maintain the projects. Their behavior is to be regulated.

Now, routinely owners and managers do not abide by those regulations, and historically HUD has failed to take any action in that circumstance. And the reasons that are given are, for instance, if we were to abate section 8, well, that may hurt the owner, but it is certainly going to hurt the tenants who are living in that property as well.

Or if we move to foreclosure, what happens? A claim on the insurance fund, and if we started doing this, what would we do to the financial stability of the insurance fund? So there has been a real inclination to avoid that kind of action.

There are other problems. For instance, owners, if we move toward foreclosure, go into bankruptcy and the whole thing is put off and goes on forever. We need new laws in that area.

In terms of the ability to run this program in a businesslike manner, HUD has demonstrated that it is capable of doing that.

As a result of hearings by this subcommittee 2 years ago, HUD set up some SWAT teams. They are dealing with some of the troubled properties in this portfolio and they are doing very well, but these are the best people. They get the resources they need to travel, they get the authority to do their jobs, they are moving, but it is a tiny section of the portfolio being handled.

Mr. SHAYS. You remind me of myself. My wife tells me I give a speech and say, oh, one more thing. You are only guilty of what I am guilty of.

Ms. GAFFNEY. This is really the last thing. This is a program that we purport is a private sector program and as everyone knows, the people who are in this program have been insulated, isolated, protected from every market force imaginable. They also are interested in money and they have become adept at getting money out of these projects. So our office has considered what we call equity skimming in multifamily insured housing to be one of the three major vulnerabilities in HUD.

So 3½ years ago we decided to go after those three areas of vulnerability as part of something we called Operation Safe Home. In the area of equity skimming——

Mr. SHAYS. I need to have you bring this to a conclusion. Finish your thought, but you are getting to a whole new area now. Finish up, if you would.

Ms. GAFFNEY. There is a problem with this portfolio that owners are diverting proceeds from these projects and are using them for their personal gain, in violation of their regulatory agreements they have with HUD and HUD has traditionally not done anything about this.

Mr. SHAYS. Say that again. What is happening?

Ms. GAFFNEY. Owners and managers in violation of their regulatory——

Mr. SHAYS. Of section 8 housing?

Ms. GAFFNEY. Of insured housing, multifamily housing, are not living up to their regulatory agreements and using the proceeds——

Mr. SHAYS. Regulatory agreements meaning what; just making sure it is well maintained?

Ms. GAFFNEY. The agreement says, for instance, that they have to cover the basic maintenance costs. They have to use the proceeds from the projects.

Mr. SHAYS. So you are saying——

Ms. GAFFNEY. That they can't take money out of the project unless there is a cash surplus in the project, so they can't take money from maintenance, for instance, out of the project and they do this.

[The prepared statement of Ms. Gaffney follows:]

STATEMENT OF
SUSAN GAFFNEY, INSPECTOR GENERAL

BEFORE THE
SUBCOMMITTEE ON HUMAN RESOURCES
AND INTERGOVERNMENTAL RELATIONS

ON
THE RESTRUCTURING OF HUD'S
ASSISTED/INSURED MULTIFAMILY HOUSING PORTFOLIO

JULY 30, 1996

Mr. Chairman and Members of the Subcommittee, thank you for this opportunity to present the views of the Office of Inspector General (OIG) on the problems facing the Department of Housing and Urban Development's (HUD) assisted/insured multifamily housing portfolio.

At the very core of HUD's creation and continuing mission is providing for decent, safe, and affordable housing for American families. Since the Congress created the Federal Housing Administration (FHA) in 1934, HUD and its predecessor organizations have administered a variety of Federal programs that have increased the supply and affordability of housing for millions of families. However, faced with shrinking resources and an increasing demand, Congress and HUD must find better ways to provide decent and affordable housing for low income families in need.

Many insured and assisted housing projects placed in service during the 1970's and 1980's for low income families are now staring at physical decline or have proven to be far too expensive. As I have testified before Congress on three occasions dating back as early as June 1994, prompt and sweeping action must be taken to deal with the Section 8 rental assistance contracts affecting these projects.

In my testimony this morning, I will provide OIG's perspective on program design flaws and HUD management deficiencies associated with the assisted/insured portfolio. As I will present later, these problems bring with them serious consequences for the tenants, their neighborhoods, and the Federal budget.

THE PORTFOLIO PROPOSED FOR REENGINEERING

As one of the Nation's oldest and largest financial institutions, FHA insures mortgage loans for about 15,800 multifamily rental properties with 2 million rental units which have an unpaid principal balance of about $47 billion. FHA insurance protects private lenders from losses resulting from borrower defaults on the mortgages for these properties. When a borrower defaults, the lender assigns the mortgage to HUD and receives an insurance claim payment from HUD for the unpaid mortgage amount. About 75% of FHA insured projects receive some form of direct subsidy from HUD in addition to mortgage insurance, including interest rate subsidies and/or Section 8 rental assistance. The project-based Section 8 subsidy is covered by contracts between HUD and the project owners. The owners agree to house lower income tenants in exchange for rent subsidies for specific units.

HUD's reengineering proposal applies to 8,636 properties that have both FHA mortgage insurance and receive Section 8 rental subsidies for some or all of their units. The Section 8 subsidy contracts for this portfolio will expire between 1996 and the year 2010. These properties have unpaid principal balances totaling almost $18 billion and contain about 859,000 units. Renewal of these contracts is expected to cost HUD approximately $42 billion in outlays during the next 7 years, and likely over $200 billion during the next 25 years. HUD reports that about 45 percent of this portfolio consists of older assisted projects with an unpaid principal balance of about $5 billion while the balance of the portfolio to be reengineered consists of newer assisted projects with an unpaid principal balance of $13 million.

Older assisted properties include those using Section 236 or Section 221 (D)(3) interest rate subsidies intended to subsidize rents for low income families. Many of these projects have a serious backlog of needed repairs affecting tenants and project viability. Over the years, the need for additional revenues in these projects was satisfied with Section 8 project based assistance.

Newer assisted properties include mostly projects insured under Section 221(D)(4) that receive Section 8 assistance on most or all units. Because Section 8 assistance for these projects is rather generous, most of these properties are in better condition both physically and financially when compared to the older assisted properties.

PROBLEMS AND CAUSES OF A TROUBLED PORTFOLIO

The insured Section 8 portfolio suffers from several serious problems, including a declining physical condition, expensive rental subsidies provided by the Federal Government, and a significant financial risk to FHA from mortgage insurance claims. We believe these problems are the result of two basic problems: first, the flawed design of the project based Section 8 program, and secondly, management weaknesses within HUD.

FLAWED PROGRAM DESIGN

The coupling of mortgage insurance and Section 8 project based rental assistance is flawed in its design and inherently risky. Insured Section 8 projects are not subject to the system of market disciplines and incentives that promote efficient and effective operation of rental housing.

Under FHA's insurance program, the Federal Government assumes almost all financial risk in the event of a default. Multifamily mortgage insurance programs require only a minimal equity investment (10%) for profit motivated owners which usually consists of noncash items such as fees and profit allowances earned during construction of the project. In the case of programs for refinancing existing projects, owners are allowed to withdraw their invested equity as part of the new mortgage proceeds.

Also, HUD insured mortgages are non-recourse, meaning that individual owners are not personally liable for the mortgages in the event of default. So, with minimal upfront investment or risk and HUD often willing to protect its investment in the property with more subsidies, owners often have little to gain by keeping down costs and protecting the interest of tenants. The overall insurance claim rate to FHA for the Section 236 program from inception is about 20%, while the claim rate for the Section 221 (d)(3) program is about 40% since inception.

Project based rental assistance becomes the primary source for meeting the growing financial needs of the projects. A disturbing number of projects are experiencing deterioration and neglect by their owners. A recent study performed by HUD reports that the insured Section 8 portfolio is in need of $3.7 billion in deferred maintenance. Owners often do not have built-in incentives to maintain properties because of a lack of equity investment and/or depleted tax benefits. If the rents are set too low, the project deteriorates and the tenants suffer and HUD risks paying an insurance claim. If the rents are set too high, the excessive subsidies pay for the windfall profits of the owners and deprive other needy families from receiving assistance.

Over one half of the projects in this portfolio have rents being subsidized at levels 120% or more above local market levels. For the newer assisted projects, these rents will continue to escalate with automatic increases every year regardless of need. As operating and repair costs rise on older assisted projects, so do Section 8 costs because of the need for additional subsidized units or higher Section 8 rents to pay for the added costs.

Unlike tenants paying market rents, subsidized families living in units receiving project based assistance are forced to remain in their units, regardless of the quality of the housing, because they cannot afford to relocate to other available housing which is not subsidized. Families become trapped if they are to continue to receive assistance and are dependent upon HUD's ability to ensure the quality of the housing.

Program design also impedes enforcement actions for substandard performance or deliberate noncompliance with HUD's program requirements. Enforcement actions often have collateral effects upon the tenants and Federal spending as HUD attempts to employ corrective actions. Typically HUD's hands are tied because effective enforcement actions trigger other events that are not in HUD's interest, such as:

** If HUD declares a default of an insured mortgage, this results in acceleration of the debt by the mortgagee, the payment of a claim from the FHA insurance fund, and a lengthy and expensive disposition process.

** If HUD defaults a Section 8 contract, this results in a recapture and rescission of the contract authority. However, the subsidized tenants are then left without affordable housing.

** If HUD abates the Section 8 payments on a significant number of units in an insured project, the cash flow decreases, the owner cannot pay the mortgage or repair the units, the residents continue to live in unacceptable housing and HUD pays a claim from the insurance fund.

** If HUD decides, as a last resort, to foreclose on a project because the owner refuses to take needed corrective actions, the owner quickly hides behind Bankruptcy Act protections to delay HUD action, and thus costing HUD more as the project continues to deteriorate. When HUD does eventually foreclose, acquire and then sell the property, yet more Section 8 is placed on the property. All this while tenants continue to live in substandard housing.

Another major problem in HUD's multifamily insured housing programs is the issue of equity skimming. Equity skimming plays a significant part in the realization of losses to the FHA insurance funds. Equity skimming is the willful misuse of any part of the rents, assets, income or other funds derived from the insured property.

Apart from the fairly obvious financial losses that HUD incurs when owners collect rents but do not pay the mortgage, equity skimming generally has other insidious implications. Most notably, living conditions deteriorate for the tenants as funds intended to maintain, replace or repair living units are diverted for the personal use of owners.

The reasons some owners violate HUD requirements and divert project funds are multi-faceted. The reasons range from simple greed to more complex issues associated with the tax laws. The bottom line remains, however, that when an owner chooses to misuse project funds, it is almost always with the idea of personal enrichment and with little worry that if and when caught, any meaningful consequences will be paid.

Once an owner gets into the "nothing to lose" position with a project, HUD must be able to promptly identify project abuse and take the steps needed to minimize the impact on the tenants and the insurance funds. HUD has not been able to respond in this manner. HUD Field Offices do not have the resources and systems to adequately assess troubled projects and take effective loss mitigation actions.

In effect, the majority of risk involved in these projects is taken by the tenants and the taxpayers. Tenants are seemingly trapped when project conditions deteriorate because their subsidies are tied to the units they occupy and tenants have rarely been able to obtain corrective actions by the owners. Taxpayers are often asked to pay for deteriorated units with excessive subsidies and to fund losses when insurance claims are paid.

As part of Operation Safe Home, the OIG has initiated an aggressive proactive effort to pursue affirmative litigation against owners of multifamily housing projects whose owners misuse project operating funds. The goal of Operation Safe Home is to stop major abuses in HUD programs that result in unacceptable living conditions for the millions of needy people who look to HUD for help. A primary objective of the Equity Skimming aspect of Operation Safe Home is to create an enforcement program that provides an effective deterrent and recovery mechanism for the misuse of income and assets at projects having HUD insured or Secretary-held mortgages. This effort is producing results. In the first 2 years, 10 criminal convictions and over $37 million in judgments, settlements, and fines involving project owners and managers have taken place. Another 105 cases are in process involving over $105 million in misused project funds. However, much more still needs to be done in program enforcement.

HUD WEAKNESSES

Serious problems with FHA management and practices have been the subject of studies, task forces and hearings for the last 20 years. As reported over and over by OIG, GAO and others, HUD's resources for the servicing of the insured multifamily portfolio are seriously deficient. HUD lacks the capacity to manage and monitor its portfolio of insured and assisted multifamily properties.

In fact, since 1987, HUD has been reporting the area of multifamily loan servicing as a "material weakness" pursuant to the Federal Manager's Financial Integrity Act. Our semiannual reports to the Congress and our financial statement audits of FHA have consistently pointed out systemic weaknesses that impact HUD's ability to manage and monitor multifamily programs, namely, inadequate staff resources and data systems, and weak management controls.

To the credit of HUD managers and staff, a newly designed asset management strategy for the multifamily insured portfolio is in place for 1996 that should improve their capabilities for mitigating losses and reducing the incidents of substandard housing. However, when dealing with the program flaws inherent to the project based assistance programs, such strategies are severely challenged in making a significant difference overall.

Staffing Resources

HUD currently lacks needed staff resources to adequately service the loans and Section 8 contracts in a manner that adequately protects the interest of the tenants and the Federal government. The staffing problems at HUD will likely worsen with the projected decrease in staffing in the Agency expected during the next few years. The skill level of the HUD staff generally does not enable them to effectively identify and assess physically troubled projects, and ensure corrective or enforcement action is taken.

For example, Field Office physical property inspections, financial statement reviews, and on-site management reviews have not been performed in a manner that consistently identifies problems. In addition, follow-up with property owners and their management agents is not sufficient to ensure that problems identified through HUD's monitoring are being addressed in a timely and acceptable manner. This often contributes to insurance claims, unacceptable housing conditions, and excessive and wasteful subsidies.

In April 1993, we issued a multi-region audit report covering HUD's servicing of insured/assisted multifamily housing projects. As part of our review, we inspected 28 troubled multifamily housing projects under the jurisdiction of six HUD Field Offices and determined that the physical condition of 23, or 82 percent, was unsatisfactory or below average. Of the 28 projects inspected, we determined that 20 had inadequate preventative maintenance programs. Our tests also showed that HUD staff had not performed any recent Housing Quality Standards (HQS) inspections for 17 (61 percent) of the 28 projects we inspected.

The audit also disclosed that HUD-insured multifamily projects remained in poor physical condition for extended periods of time and that units receiving Section 8 assistance often failed to meet HUD's housing standards. With respect to the latter, we inspected 314 Section 8 assisted units and determined that 216, or nearly 69 percent, failed to meet HUD's housing standards.

We reviewed the staffing level at the 6 HUD field offices included in the audit, and found that the workloads of the loan servicers widely varied from an average of 105 projects per servicer in Detroit to 28 per servicer in Kansas City. The average for the 6 offices was 57 projects per servicer. In addition to their loan servicing duties these staff had also been assigned additional duties to administer newer programs such as the Preservation Programs (Titles II and

VI), monitoring State Housing Finance Agencies, along with other functions transferred to the field from Headquarters such as foreclosures, review of proposed project sales, and workout agreements.

Another factor hampering performance was the skill level of the loan servicing staff. Managers and staff must maintain a level of competence that allows them to accomplish their assigned duties. Managers in three of the six offices included in our audit reported that their staffs were not adequately trained to perform their jobs. We also learned that 4 of the 6 offices did not have any financial analysts on their staffs. Much has been done by HUD in the last few years to design and conduct training for loan servicers. However, budget constraints on HUD will continue to impact this area.

The high project to servicer ratio, the added responsibilities, and lack of training hampers the servicers' ability to prevent or remedy problems. In the search for yet new product lines and larger market shares, FHA staff can expect to be further burdened with new loans to service and new programs to learn. For example, the Secretary has decided to make health care facility financing, including mortgage insurance for hospitals, nursing homes and community health centers an important component in his recent plans to transform HUD. These and other programs distract HUD from improving the delivery of its core programs for providing decent, safe and sanitary housing for low-income persons.

Another demonstration of the scope of HUD's staffing shortages in this regard was contained in a 1993 Price Waterhouse audit report on FHA. That report pointed out the wide disparity between staffing levels at HUD and at other entities involved in multifamily housing lending. Whereas state housing finance agencies have staff/loan ratios of 1 to 20 and private institutions of 1 to 15, each HUD staff person has an average workload of 50 loans. Price Waterhouse went on to point out that HUD loans are typically much riskier, more troubled and thus more staff intensive, making the noted disparity even greater.

Management Controls

Management controls in the form of supervision and performance measurements have not been effective in ensuring that the mission and objectives of HUD's loan servicing function are being properly carried out.

The use of performance measurements is relevant to the administration of HUD's multifamily mortgage insurance programs for determining whether what is being done is making a difference. Our audit of loan servicing activities in 1993 disclosed that 5 of the 6 offices examined did not measure the performance of loan servicing qualitatively. HUD's measures used for evaluating performance in its multifamily programs focused on such activities as the amounts of funds expended, units subsidized, on-site reviews performed, management reviews completed and physical inspections performed during the year. Although 5 of the 6 offices achieved the goals established for them during the year, their success in correcting project deficiencies was dismal. These offices could not identify for us those projects having substandard living conditions, the length of time projects remained in disrepair, or the amount of insurance claims paid for the last 3 years or even the current year.

While recent OIG surveys of the Office of Housing's performance measurement and resource management found an improvement in the reporting of some program input and output measures, there is a continuing need for outcome measures and the use of performance measures in day-to-day program and resource management. The annual *Housing Management Plan* is the primary means of setting priorities and monitoring accomplishments. Field operating units set their own goals, and headquarters does not review the reasonableness of the goals relative to available resource levels and the volume and complexity of workload. Essential functions are still inadequately performed in many offices, such as reviews of subsidy payment requests, and follow-up and enforcement action on the results of contracted project monitoring activity.

In our audit of HUD's loan servicing activities, we also found that most financial reviews and on-site management reviews that we examined had no evidence of any supervisor review to ensure these assignments were properly performed by the staff. Supervisors attributed their lack of oversight to a lack of time and no established system requiring supervisory review.

Data Systems

The impact of staffing shortages could be offset somewhat through economies relating to the use of automated data. However, HUD does not have effective and integrated automated data systems that can be relied upon to provide relevant, timely, accurate, and complete information.

Financial performance data on projects, while improving, continues to be inadequate. Data systems do not provide information usable for the early detection of troubled projects, and assessing and resolving project difficulties. Numerous past attempts to develop a useful system have not been successful. Management must establish accountability and responsibility for project management, technical support, data quality, documentation, and training. Inadequate data systems has contributed to fraud, waste and mismanagement in many of HUD's programs, including the Section 8-assisted multifamily housing programs.

GUIDING PRINCIPLES FOR ACTION

As can be seen very plainly from the many years of problems that have plagued insured Section 8 projects, drastic changes are needed in the way HUD provides housing assistance to low income families. The expiring Section 8 contracts for these projects and the sizable impact that renewals will have upon the Budget have brought these problems to the forefront. We commend HUD for recognizing this problem and for their work in trying to develop a solution during the last 2 years.

Even as the budget crisis comes upon us, however, real progress toward achieving an agreed upon solution appears exceedingly slow. There seems to be agreement that this system of assisted/insured multifamily housing is costing too much. But there is concern that moving away from the current system will mean losing this stock of "affordable housing"; place tenants -- many of them elderly -- in the position of fending for themselves with tenant-based certificates and vouchers; and force owners to pay substantial amounts of capital gains taxes. There is also significant anxiety about what the costs would actually be. This is turn relates to HUD's lack of good data on a project level; HUD's management inadequacies; HUD's understanding of private sector motivations and probable reactions to portfolio reengineering; and HUD's ability to work with third parties as partners in portfolio restructuring.

If the OIG had a silver bullet policy solution, I would offer it now. We don't, of course; but we do offer the following considerations, which we believe are essential to devising the appropriate policy.

Expiring Section 8 contracts provide an opportunity to implement new housing assistance policy that fits within the total welfare reform debate. Currently, HUD rental housing assistance benefits only one-third of the households in need in this country despite the billions a dollars expended each year. And HUD reports the number of households spending over 50% of their incomes for housing continues to rise each year. With the reduction of Federal funds available for welfare programs, the future looks bleak for those many in need. Transitioning from Federal assistance programs to self-sufficiency must be ingrained in to our housing assistance programs if there is to be any chance of having enough resources to benefit all the families who deserve help.

As discussed earlier, many of the project in the portfolio have rents in excess of the market and are in need of a great deal of rehabilitation. Clearly this is not a stock of affordable housing when the rents are neither affordable to private renters or the Federal government. Where housing is available at market rates, the need to preserve the housing as project based assistance should be closely examined before committing additional Federal support.

During the last two years, the debate over the usefulness of vouchers has continued without resolution. HUD reports that, in large part, tenant based assistance provides a good mechanism for meeting the housing needs of low income families. Yet, too often, there are examples of families that have found vouchers to be unusable. Some cases would indicate this form of subsidy does not provide the level of assistance needed to make available housing affordable, while others find landlords reluctant to accept vouchers because of the additional costs or burdens placed upon them by the Federal government when compared to renting to unsubsidized tenants. These problems need to be addressed.

The combination of mortgage insurance and housing subsidies leads to unbusinesslike stewardship and additional subsidies. Congress and HUD must develop programs that take full advantage of market forces to ensure the quality and cost of housing is reasonable. We must understand what brought us to this point and what factors are likely to influence the future of the portfolio. Keeping project based assistance programs in place while only reducing Section 8 payments by restructuring mortgages will not fix the problem. Rather this is just a shuffling of the cost of the program from one appropriation to another. Much more needs to be done.

HUD's difficulties in designing a proposal to deal with the expiring Section 8 contracts and in estimating the costs of its restructuring proposal are indicative of the inadequacies of its data systems and lack of information on rental markets and the condition of projects in its portfolio. However, HUD's recently completed study on a sample of the portfolio to be reengineered has been a significant step forward in arriving at answers to the many questions about reengineering the portfolio.

HUD's ability to service its multifamily portfolio has been totally inadequate over the years, as discussed earlier. Thus, there is the question whether HUD has the capacity to implement and carry out a much more higher complex endeavor as portfolio reengineering in an effective and timely manner. HUD's capacity will become even more strained with expected staff reductions due to budget cuts and HUD's propensity for developing new markets and product lines for FHA. Our Office has not conducted any in depth analysis of the numbers and types of personnel that would be required to effectively carry out the proposed restructuring. However, several successful mortgage sales by HUD offer some hope that FHA could complete portfolio engineering if it was patterned after the sales program. The use of contractors, consultants, and third parties will likely play an important role in the plan to reengineer the portfolio. Oversight of those participating in the process outside the government will require our full attention.

Mr. SHAYS. Let me say that you lived up to one of our requests to a former inspector general when we said if you don't tell us these problems, don't expect us to deal with them. So you did your job. Some of it, we all know, the bottom line is that we have—Mr. Secretary, you really made an excellent statement in terms of basically certain principles and so on, so really you touched on it, but we needed to have some of it filled out however difficult it is to sit next to it and realize. But I don't think anything is said here that basically we all don't know to some degree or another.

The purpose of this committee and the hearings we have is going to be obviously to force Congress to encourage Congress to kind of wrestle with this issue a little sooner. In fact, we are too late in some cases, but sooner than we would do it if we didn't have these hearings, but to then come in with specific recommendations. I am kind of overwhelmed in one sense because, Ms. Gaffney, you are basically saying something I think we all know, that HUD doesn't really have the resources or expertise or the company culture at this moment in time to deal with this problem and Congress doesn't have the inclination to want to have to wrestle with the fact that we have to provide some significant resources. So there are a whole host of factors here.

Let me just ask you, Mr. Secretary, first, to say to you that one of my problems and why I have asked the questions early on, I had forgotten that the guarantee only lasted 20 years.

Mr. RETSINAS. The guarantee of the subsidy was 20 years. The insurance guarantee lasted 40.

Mr. SHAYS. Right, and two very key points. So I basically had made an assumption that the guarantee of the property, the insurance ran out in 20 years along with the subsidy. So you can understand—so you make assumptions that that is such basic knowledge, any idiot should know it but this idiot, that got by him. And so that just kind of gives a little more reality to what I have been trying to wrestle with.

Bottom line, the mortgage insurance is there for 40 years. Someone who wants to prepay it can prepay it in 20 in some instances. After 20 years they can buy out of the system; is that correct?

Mr. RETSINAS. In some cases. I think the other issue that you are referring to, because it was under immense discussion when you joined the Congress, in certain parts of the country more so than others is the program my colleague from GAO referred to as preservation, the Low-Income Housing Preservation Act. Under that program mortgages that were originally insured for an extended period of time had prepayment provisions within the mortgage.

This is, in a sense, independent of the subsidy contracts because not all insured developments have rental subsidies—had a provision in those mortgages, the so-called section 236 program. Not to throw numbers around, but those programs had a provision that said after a period of time that is, 20 years, the owner would have the right to prepay, which means pay off whatever the unpaid principal balance is and therefore avoid any further obligation to provide affordable housing.

The Congress in the late 1980's said this isn't acceptable because in certain parts of the country people would have no place to go. Therefore, let us have a special incentive called a preservation program that would allow us—I want to use as commonsensical terms as possible—that would allow us to compensate the owner for not exercising that prepayment right. So it is a fair question, maybe a little different than the subject at hand, but that remains today a very important issue.

Mr. SHAYS. Let me ask this question. What form of tax relief do property owners tell HUD that they need to induce them to participate in extending and not buying out? What do they—what is the basic—what will we have to do? I want to talk about that part of the program. Refresh me because that was something I was active in and kind of backed off of it. What has been the results?

Mr. RETSINAS. Focusing on tax relief, these are all part of a larger course. What many owners—like the video tape, there are owners, and there are owners, and there are owners. What many owners have indicated is that if there were to be a restructuring of the kind envisioned in our proposal or parallel proposals, a restructuring that would involve, as Congresswoman Morella noted, a reduction in the outstanding indebtedness to a level that could be supported by the true market rent, not the artificial rent, the difference between the original indebtedness insured by HUD and the restructured lowered indebtedness is likely to be considered a tax event by the IRS.

I am not a tax attorney, but the tax event is that that cancellation of outstanding indebtedness is the functional equivalent of giving someone money, because instead of owing it you no longer owe it. Property owners and investors—most of these were developed under a limited partnership structure—those investors would therefore have on their tax return a dramatic increase in taxable income, but not in real income. While the indebtedness would go down, the owner would get no increase in income because the subsidies would be reduced.

What the owners have asked for is some form of, to use their expression, exit tax relief, that would allow some deferral of that tax exposure.

Mr. SHAYS. Who owns most of the notes on section 8 housing?

Mr. RETSINAS. The mortgages are held by a variety of different lenders. The equity portion of the ownership is generally owned by a whole series of limited partnerships, more individuals because of the historical nature of this.

Mr. SHAYS. I am basically left with a feeling that we don't have any answer right now, that no one has a solution. That is where I am at this moment if you had to have another confessional here, that the Department doesn't have a solution, the Congress doesn't have a solution, and you know, and so I am just wrestling with where we go from here.

Mr. RETSINAS. I believe there is a solution. Certainly there is no solution that has been accepted by all parties. But that ought not to be surprising. Let's think about the context. We are talking about a situation of how we deal with a substantial diminution in subsidies or assistance. If the status quo is always the comparison for any solution, except for the taxpayer, it will almost always fall short. From the point of view of tenants and owners of property, for profit and nonprofit, insuring a continued stream of subsidy over time is almost always preferable to getting less money.

So I think you are right from the point of view that there is no solution that everyone accepts, but I think there is a solution, but clearly the administration has not been able to craft it in a way that has found acceptance within the Congress.

Mr. SHAYS. I am stuck with the fact that basically in one sense the developer is in the cat bird's seat in the sense that the political reality is we are not going to have people be homeless and the political reality is we are going to do our darnedest to increase the living quality of people who live in public housing. But in one sense—let me throw out a scenario.

What happens if HUD simply said we aren't going to subsidize at this rate, we are going to pay the market rent and nothing higher, period. Some units will go under and some units won't. In some cases, we are not even paying the market rent, so we would have an increased cost.

Take the scenario where we are paying above the market rent—I remember we had one individual who came before us who I know made a tidy fortune earlier on, a tidy fortune. Now, these facilities are not in the best neighborhood, they are in deplorable condition and he is getting a rent higher than someone living in a nicer facility in a nicer part of town. So I basically want to say screw you, we are out of here. Give me the scenario, short and long term.

Mr. RETSINAS. In the near term, if Congress and the administration said that in the future when a section 8 contract expires, because that is what we are talking about, when a section 8 contract expires, when that contract expires, we will no longer pay whatever the current rent is, the current subsidized rent, but we will pay no more than the market rent. Here is what would happen.

First of all, the owners of the property would see this coming because that would be the policy. For many of those properties that are substantially above market, two-thirds of the total inventory over time, they would begin, I believe, to disinvest in that property, understanding that they are going to reach a point where they would lack sufficient rental income to pay the debt service. So therefore they would proceed to delinquency and then default.

Over time the Federal Government, the lender, when the owner is unable to pay his or her or its mortgage payment, would then assign the note, the mortgage, to the Federal Government. We would then hold the note and eventually go through a process of either selling the note or foreclosing on the property.

Mr. SHAYS. Basically, these units, though, are getting something above and beyond what their mortgage payments are.

Mr. RETSINAS. No. They are getting a subsidy level that is necessary to retire the existing mortgage. It is not above their mortgage level.

Mr. SHAYS. There has to be some operating included in that. I am trying to divide it up, a payment to the note holder and then there is this balance——

Mr. RETSINAS. Operating expenses.

Mr. SHAYS. They can't, this kind of goes to Ms. Gaffney. Do we have an inability to be very specific as to how much they have to spend to maintain the projects?

Mr. RETSINAS. They submit annual reports on what their operating expenses are.

Mr. SHAYS. I make an assumption that the local housing authorities monitor these projects.

Mr. RETSINAS. Generally not. They are monitored by HUD field offices. In some cases local housing authorities monitor the section 8 contracts, but the projects themselves——

Ms. GAFFNEY. The housing authorities do the tenant-based section 8.

Mr. SHAYS. I am just—again, we bring in our own experiences. We are dealing with a circumstance now which is tenant-based. Bottom line, let's just talk tenant-based, there HUD oversees them, correct?

Mr. RETSINAS. Local housing authorities oversee it.

Mr. SHAYS. But in those instances they should have the ability to know how much is being spent. I don't understand why they couldn't on a weekly basis say this is what you have spent to maintain, and we are not satisfied with how they maintain. I am just trying to deal with how do they disinvest, in a sense?

Ms. GAFFNEY. There are multifamily projects where there is no evidence that a HUD person has gone near them in years.

Mr. SHAYS. Forget the HUD person. I want to talk about the housing authority. I just want to talk about the tenant base. I am trying to get a little simple piece out of this. I am going to be leaving here a bit confused; I accept that. I am trying to take a little piece here and find the logic. I am trying to understand the culture that exists on your side of the table here and what you have to deal with.

Mr. Secretary, you have been at HUD for how long?

Mr. RETSINAS. Three years, five weeks and three days.

Mr. SHAYS. Even if you made that up, I love that.

Mr. RETSINAS. It is true.

Mr. SHAYS. That is wonderful that you know that. Bottom line, there is a different culture at HUD's. I am not being critical. In your activity in other employment it was just different. I am trying to understand the environment you find yourself in and the environment of the others who work there.

There is a culture and it is a very real culture that we are looking to change. But HUD housing authorities have the ability—I am just asking this—do they not have the ability almost on a weekly basis to go over the books and know how much is coming in? They do not have the ability to take over these tenant-based facilities; is that correct?

Mr. RETSINAS. No, it is not, Mr. Chairman.

Mr. SHAYS. This is like a game of chicken, who is going to do what first. I wonder if in some cases you don't call the question. I guess you don't call the question until you are ready to deal with the results of that. You have this recalcitrant developer who may have very little to run the development well because he has taken out a lot before.

I won't pass judgment on that. Bottom line, he is above market, he is getting above market, he or she has a high note to pay, but in there there is something to maintain the property.

Are you telling me that within that there is not enough money usually to maintain the property or is maintaining the property such that they have to do capital investment to bring it up to the point that you want it maintained?

Mr. RETSINAS. In some cases there isn't enough to maintain the property even with high rents in part because of deterioration over time and in part because of unintended consequences of actions that we together have taken. If you will recall years ago, we, Congress and the former administrations, changed the rules that changed the preference requirements. So now, generally speaking, most developments are almost exclusively for very low-income persons who need special services.

Mr. SHAYS. We have some tenants who have no sense whatsoever of what is involved in maintaining the facility and doing their part in the process. We also have facilities where kids run rampant and run without any supervision. In some areas that I am familiar with we have public housing that is reserved just for seniors that is extraordinarily well-maintained.

Mr. RETSINAS. I agree.

Mr. SHAYS. And others, that new facility with kids that moved in, we had a facility where we had seniors taking care of it and because of the law of four units in a high-rise, we had to bring in the kids, and the kids just destroyed it in no time. Which leads me to feel that part of the solution that none of us have talked about is the role of the tenant. There is a definite role of the tenant and we should be investing in the tenants who are in to try to teach them how to grab hold of their place and maintain it.

Mr. RETSINAS. I would agree. I don't want to go over the laundry list of initiatives, but one of our major priorities over the last year is a program called Neighborhood Networks, which is putting learning centers in assisted housing developments tied in with community colleges and job training, doing just the kind of thing you are talking about, investing, not spending money.

Mr. SHAYS. I am going to lend myself the next 10 minutes. I want to go through your principles. You can't wait for defaults. Need to be proactive. I don't think we can wait.

I am just interested if we shouldn't and calling the question in a few instances and maybe we pick it. Some landlords that are being so bad that we take the risk and that we have an agreement with HUD and Members of Congress that we are not going to be critical that you have done that and that. We are going to almost consider that a pilot program.

In terms of let us use the market as the motivation, I think that has to be and, frankly, we can't repeal the laws of economics. I don't quite know what that means in terms of action, because the marketplace, to me, says basically you don't pay more than the market rate. You literally call the question and then you pick up the pieces after you have called the question.

Mr. RETSINAS. I might add, Mr. Chairman, that is an issue where we probably have the most difference of opinion with your colleagues on the issue of the role of the market.

Mr. SHAYS. There are some in Congress who at least talk about wanting the marketplace to be supreme, but we don't always practice it. You are less inclined to use the marketplace or more inclined?

Mr. RETSINAS. I believe the market is one of the ways we can deal with the staffing overload that my colleague noted.

Mr. SHAYS. So what you are taking about is in terms of internal operation of HUD?

Mr. RETSINAS. No. I think Government should pay what other people pay. I believe we ought to use the market.

Mr. SHAYS. But there are other things. That introduces choice and a host of other things.

Mr. RETSINAS. Yes.

Mr. SHAYS. The partnership approach is you visualize—when I think of what you said about partnership, it is that basically we assume over time we are going to take over a number of different units. We plan now, because they are going to be defaulted on, and we plan now to have someone else take them over instead of HUD.

Mr. RETSINAS. The only variation is we are recommending that action be taken before there is ever any default. For example, in your home State, we would look to an actor like the Connecticut Housing Finance Authority and say, OK, we know this contract will expire next year or 2 years from now.

We know what the dates of the contracts are. Will you work with us, with the project owner to restructure the financing such that after it is restructured the rents that are required to pay off the mortgage don't exceed the market rents? So there is never a default. The idea is to avoid default.

Mr. SHAYS. I get the sense that given the makeup of Congress, whether it is Republican or Democrat, but given the shift in Congress, there are going to be some who are going to force this hand on all of us by simply saying we are not going to pay it. Congress may just simply refuse. And if Congress doesn't appropriate it, doesn't have it, these are not entitlements. So I have a sense of where we are headed on this one.

You can't abrogate existing contracts. What did you mean there?

Mr. RETSINAS. Notwithstanding what you just alluded to, which is the budget crunch, there is something fundamental about the notion that if the Government negotiated a contract with an owner, for profit or nonprofit or whatever, for *x* period of time, while it is, of course, subject to annual appropriations, we would argue that existing contracts be honored. So even if we are paying above market and the contract doesn't expire until 1999, we believe existing contracts ought to be honored. We argue for a proactive restructuring. But there is a fundamental principle that honoring contracts——

Mr. SHAYS. I would agree with that. You gave me basically three choices in terms of how you set the rate.

Mr. RETSINAS. Right.

Mr. SHAYS. Your preference, I guess, was right now the rent is what the project needs—that is not your preference. You have the rental market, you have the market rate, a percent of the market rate——

Mr. RETSINAS. Not percent of market rate, but some artificial number.

Mr. SHAYS. But definitely artificial.

Mr. RETSINAS. Right.

Mr. SHAYS. The problem is when you set market rates sometimes you don't know if HUD is artificially increasing the market rate. Our vouchers, in some cases, are higher than the market rent even though we think it is the market rent. It is difficult sometimes to know what the market rent is.

Mr. RETSINAS. The term is fair market rent, which is an artificial creation. I am not talking about fair market rent. I am talking about real sorts of market rent where working with the lender, a lender knows what other properties are being rented for. That is how you determine market rent.

Mr. SHAYS. In terms of your talking about the use of third parties, HUD is doing it with contractors and third parties, that is back to the point of the partnership. Tell me again so I have a better sense of what you consider a partnership?

Mr. RETSINAS. A partnership is where your partner has the responsibility for restructuring in a way that if the restructuring succeeds, the partner benefits. If the restructuring fails, the partner does not benefit. It is the notion of the risk sharing I mentioned before, Mr. Chairman, on the multifamily production program.

Mr. SHAYS. The challenge will be so we don't end up with what we ended up with when we had HUD hearings a few years ago with Mr. Pearce about how you decide who your partners are because that could be gigantic.

Mr. RETSINAS. Our preference would be to work with public sector partners or nothing. Not that anything avoids all problems, but we think that is the prudent course of action.

Mr. SHAYS. Let me say that the staff's basic comments to me are that your heart is in the right place and you have done, I think, a very good job of articulating the challenge. Before Ms. Gaffney made her comments, their comment to me is that the agency's main problem is a lack of management capability in terms of what is available to you as someone who comes in here after 3 years, and you come in with staff expertise.

We are charting new territory, it seems to me. So I need to say to you that what Ms. Gaffney has said, we have had a dialog a long time on. I just wonder if you have the capability to do it with existing resources. The answer is, no, I think you would agree; whether HUD has the company culture to do it, and I would say, no, and I would be interested to know what your response would be.

Mr. RETSINAS. I would say we are getting better. Ms. Gaffney is right. For many years there was a culture that said, do all that was possible to avoid an insurance claim because of a primacy of focusing on the financial situation.

Certainly over the last 2 to 3 years we have had a different criteria. So, for example, while we could certainly do more enforcement, we have done more enforcement activities, including abrogation of contracts and the like in the last 2½ years than in the previous 10 combined.

Is there a ways to go? Yes. This is a large entity. I think we are moving in the right direction, but my concern is unless we make the fundamental changes that we have all talked about, by the time we get there it will be too late in terms of the cost to the taxpayer.

Ms. GAFFNEY. Mr. Chairman, could I say something? It seems to me there are two different issues. One is does HUD have the capability to manage on an ongoing basis? But the other question is does HUD really have the in-house expertise to do the re-engineering, to design, to carry it off? That is a really important consideration because, you know, there is a lot of expertise out there in the private sector—people who have been through this with the RTC, they know this business. We really don't have people——

Mr. SHAYS. It leads me to the point that I was going to ask both of you. Should we be considering in our report recommending that HUD basically go out—in terms of the concept of partnership, but maybe it is a little different—go out and—let me preface my point.

If this were the private sector and you were running the company and you truly knew the resources you had at hand, wouldn't you be inclined to go to a Booz Allen or go to some of the organizations that were set up when we had the savings and loans and pick out the best and the brightest and say we are going to set up a corporation, or we are going to give you these properties and see how you can resolve them?

Mr. RETSINAS. Two answers to that. One, that we are indeed using some of those expert resources that you talked about. In all candor, I can't think of any organization, including the Federal Government, that has the in-house capacity to do a restructuring of 900,000 units. No one would expect that, whether it be an RTC or any kind of organization. So, yes, we are doing so.

One of the inhibiting factors is the nature of the procurement process and the other processes we use in gauging that assistance is a laborious process. Given the length of time it takes to go through the procurement process, if I were in the private sector, I would do it more quickly, have a process in terms of selecting that help, but our proposal is predicated on the use of third parties to execute this proposal.

Mr. SHAYS. All of what you said is why I am just wondering if in the end we are not going to say the solution is to take this away from HUD with no disrespect to HUD. The problem with the pilot programs is by the time we learn from the pilot program we are in the mess. So in a way, it has been covered for me. I have been able to vote for this pilot program, but basically all I have done is I have done nothing, with all due respect. We have done one thing. We were going to deal with 15,000 units, I guess that is the number, but we are not dealing with 900,000. So this may be a dialog we need to have not necessarily on the record because we are just brain storming right now, I am. But I am left with a feeling that this committee needs to make some real noise about the fact that we are beyond the point where we can even look at a pilot program, that we have to do something more substantive.

This committee has no inclination to go after HUD in any way, because this is a long-term thing that has been here for a while and we need to collectively say, hey, we are in this now. What do we do about it.

The bottom line is I buy your point, I think you alluded to it, that HUD does not have the expertise given the magnitude of the problem and that we are going to have to find some solution that is not yet on the drawing board. That is kind of where I am left. You are welcome to respond.

Mr. RETSINAS. The only comment, I believe we do have the expertise in terms of knowing what to do. Where I do agree wholeheartedly with my colleague is that we do not have the capacity to execute on an individual basis. That is why the partner principle becomes critical.

Mr. SHAYS. I accept that. The policy issues are still—I know that people have the ability within HUD to deal with some of these policy issues. I think the solution, though, is something none of us have talked about. So it would be nice to have the synergy of others involved in it.

Thank you for listening to me. I think I have spoken more than I have asked, but I have learned a lot and you both have been wonderful witnesses. We look forward to working with GAO and HUD and the inspector general to see how we can be helpful.

We are going to end with one witness who carries a great burden for everyone else whom she will be representing. Carol Severin is our last witness.

[Witness sworn.]

Mr. SHAYS. Before you give your testimony, if you would tell me in a sense, I could have asked my staff this—what do you bring to the table? What is your basic—it will help me be able to focus on your message better.

Ms. SEVERIN. Of the 10 projects, 1 studied by the GAO that was in the video is one of our projects.

Mr. SHAYS. In other words, you own this project?

Ms. SEVERIN. Yes. I am the president and CEO of a nonprofit corporation that develops low-income housing for elderly and disabled people and I am here today representing the American Association of Homes and Services for the Aging.

Mr. SHAYS. Your perspective is from the developer, but you are really a nonprofit developer, correct?

Ms. SEVERIN. Right. My perspective is from the perspective of a nonprofit housing corporation that is community-based as well as representing the residents because we are mission-driven instead of profit-driven and also representing the special needs of elderly and disabled people——

Mr. SHAYS. Would my characterization be that someone in your position is not looking to find a way to get out of a long-term commitment to help people?

Ms. SEVERIN. Absolutely.

Mr. SHAYS. Your perspective is not I own this property, now I can buy it, and now I can serve a different clientele?

Ms. SEVERIN. Absolutely.

Mr. SHAYS. So the one weakness, I think, in our hearing is we don't have someone who is a private developer who said when I retire 20 years from now I am going to be 65, I can sell this property. Is that a fair——

Ms. SEVERIN. That is correct.

Mr. SHAYS. Believe me, if I bought this property as a private developer and I knew that in 20 years I could buy out, that is my right.

Ms. SEVERIN. I agree. I would like 6 minutes, Mr. Chairman. I have a prepared statement of 5 minutes and I would like to add to it.

Mr. SHAYS. You will have 10 minutes. I have rolled these over. I may have talked a lot, but I have allowed you all to talk, too.

STATEMENT OF CAROL SEVERIN, BA, M. DIV., PRESIDENT AND CEO, SATELLITE SENIOR HOMES, INC., AND AFFILIATE CORPORATIONS REPRESENTING AMERICAN ASSOCIATION OF HOMES AND SERVICES FOR THE AGING

Ms. SEVERIN. Good afternoon, Mr. Chairman, and if they come in, the other members of the Human Resources and Intergovernmental Affairs Subcommittee. I am the president and chief executive officer of Satellite Senior Homes, which is a nonprofit corporation that develops, owns and manages housing for low-income elderly and disabled people in the San Francisco Bay area.

Mr. Chairman, our property is much like you described with your constituents in that our corporation is mission-driven and our buildings are all sponsored by churches or religious organizations or civic organizations, Protestants, Catholic, the Jewish Federation, et cetera.

Over the last three decades, Satellite has developed and manages 15 HUD-assisted facilities and we serve approximately 1,200 very low and low-income elderly residents, many of whom are frail or disabled. One of our projects is St. Andrews Manor in Oakland, CA, and St. Andrews is 1 of the 10 case studies which was on the videotape that you saw today.

I am very pleased to be here today representing the American Association of Homes and Services for the Aging, where I have served as a member on the public policy committee. I would also like to take this opportunity to commend the GAO on the honesty, integrity, and the fairness with which they undertook their study. They were very sensitive to our residents and to our mission when they came and videotaped the facility, and we were very apprehensive at first and then very appreciative.

We also would like to note that we have had a lot of support from our local HUD office in all of the studies that were conducted on our buildings and we have tremendous respect for the D.C. HUD staff for tackling this huge fiscal problem. We believe they have done so fearlessly by authorizing some of the first real proposals to deal with the problem of dilapidated buildings that are substandard and extraordinary profits that some for-profit owners have made off the Government.

So it is in that context that I offer my following comments, and I believe that we will have more in common with the GAO and HUD than not because we are talking about a particular type of developer and a type of development and a commitment to the community and a particularly frail population which most people would agree needs assistance.

So while we understand that the section 8 renewals place great stress on the HUD budget and it has been described very well today—we usually hear of it as a train wreck, avalanche, tidal wave. We understand the fiscal constraints as much as we can out in the field. However, we believe that federally assisted nonprofit housing is a very distinct part of a restructuring equation that should be addressed separately.

So I will speak about four topics. The first is a description of the residents in our buildings.

Mr. SHAYS. I want to say, I agree. I do think it should be done separately. I think they are very unique. You don't have to spend a lot of time convincing me.

Ms. SEVERIN. Good. The role of nonprofits in restructuring and the importance of project-based subsidies and services for certain special needs populations like the elderly and the role of affordable housing and the long-term care of the elderly, is a topic which I don't believe is being addressed anywhere at this point except through AAHSA and its members. A portrait of the elderly members in federally assisted housing reveals a population that is very poor, very old, very frail, very disabled.

Some are blind, some are deaf, some are in their eighties and nineties. Their average income is about $8,000 a year, which is equivalent to only 18 percent of the area median income nationally. Our residents will never get well, get younger, get a better job to pull themselves up by their bootstraps to get out of poverty.

Many have worked their entire lives at low-wage jobs and now are destitute, forced to make devastating choices between buying food or buying medicine after they pay their rent. HUD-assisted housing programs are the last protection that keeps low-income elderly and disabled people from being forced to live on the streets.

Our Nation's elderly residents who are low income live in chronic fear of losing their housing. One of the things we are required to do is to send out a notice 1 year in advance that says we can't assure you of a section 8 certificate. You are most likely to have another type of subsidy. We use the exact words that HUD uses in order to do the letter, but you can imagine the residents are terrified.

They read the newspaper, go to the senior center and keep up on issues of public policy. While the 202 elderly program is somewhat protected, there is some acknowledgment that the elderly can't fend for themselves in the markets. There are other projects which house the elderly like the 236 program, which has not been put into that 202 program at this time, so the elderly are in chronic fear. Our phones ring off the hook with people concerned that they are going to lose their housing.

The nonprofit housing development industry has grown immensely in numbers and in capacity and has become the most efficient and responsive affordable housing producer. For many nonprofit housing organizations, production and management of low-income housing has been part of a larger community development strategy with a commitment to address resident and community needs that go far beyond housing.

For the senior and disabled population, there are services that are critical to avoid costly institutionalization or homelessness. I would like to add also that a nonprofit corporation like ours can leverage additional services and funds for elderly that a for-profit wouldn't be able to do.

Our St. Andrews project—since I have 10 minutes, I will tell you a bit about it. In the St. Andrews project we were able to get United Way funding, Kaiser funding, local funding. We got a black elder project because our residents are primarily African-American. In the black elder project, $60,000 that went into discerning what the needs are particularly of black elders in the inner city.

We have received all kinds of additional services from the community like van services. We have gotten a nursing school to come and provide free medical care for our residents. We have got a community policing program which was spun off one of the HUD-funded drug crime programs, where the police officers come in and sit with residents when they write their reports and escort the residents to get groceries or to a medical appointment.

We are working on another program where the police cadets would work with our residents just to figure out what it is like to be so old and frail and disadvantaged. So that is another thing the nonprofit industry brings to this wider debate. The nonprofit commitment to the wider community on long-term affordable housing is qualitatively different from profit motive owners.

We need policy makers to design strategies which should encourage nonprofit acquisition of the debt restructured properties, and we could bring some more specific recommendations from some of the nonprofit developers. Much of the debate has centered around the HUD proposal to transfer these project-based subsidies to tenant-based vouchers. However, in many highly concentrated urban areas and high cost markets, the vouchers will not guarantee decent housing.

For properties that have special needs populations like the elderly or disabled, it is critical that the Federal subsidy remain project-based. Project-based subsidies are a Federal commitment to the long-term housing affordability that is needed for these populations.

Mr. SHAYS. Why couldn't you compete like anyone else if you provide such great services. I am not sure why it has to be project-based if ultimately you provide such a great facility?

Ms. SEVERIN. One of the reasons is because we would have such a high vacancy rate. We have about a 25-percent turnover each year because people go to hospitals, they go home to die in hospice with overcrowded family conditions. They just simply die. So there is a huge turnover rate and there is such an enormous need for housing that even with restructuring, if everyone were given a voucher we would not be able to fill those apartments.

We have done a financial analysis every time we get a new proposal from GAO or HUD as to how it might be restructured, and in every one of them the buildings would go bankrupt within 1 year. There is also the problem that there are no comparable units.

When the GAO came out to visit us at one point and when an appraiser came out, what we saw were fourplexes on second stories with no elevator, with no amenities for seniors, with apartments so small that you couldn't turn a little wheelchair around in it. It was completely inappropriate. So A, there are no comps and B, there is a huge vacancy problem that we would have. Those are the primary issues.

St. Andrews is in a neighborhood that is economically distressed through loss of industry and much of the surrounding housing is substandard. So if St. Andrews were unable to compete in the market, the neighborhood would lose a very important source of affordable housing.

As I said, there are no comps in the community and the comps that we looked at were completely inaccessible. Because of the high degree of services and the complete lack of comparable units, we do not believe the majority of our residents would opt to leave if they were offered a section 8 tenant voucher.

Additionally, many of our residents know from lifelong experience that in for-profit and competitive markets they have already faced severe discrimination based on their age, disability, frailty, race, source of income, and accommodation needs.

As I just spoke of the vacancies, the project restructuring is another key issue which impacts the projects financially and in our projects when we did the analysis, we saw that they couldn't make it past 1 year even if the debt were entirely forgiven. It would be basically up to us to market, to pick up the lucky few people who have the vouchers, which now, if you look at some housing authority waiting lists, they will open up the list for 1 day and look at 4,000 applicants.

If you look at our projects, one has a 10-year waiting list, so we have had the waiting list closed for 3 years and we purge it every 6 months. We still have a 10-year waiting list. So people who are waiting are already excluded from the market. They would not have vouchers.

What would happen is the people who were in the projects would get vouchers, and then for our population, they would die, and would those vouchers be replaced? We don't know.

Mr. SHAYS. The dialog about vouchers, there are always solutions for everything you have mentioned. I don't know if we want to just have a long dialog about vouchers, but there are ways you would structure a voucher to allow you to be competitive with someone else. If you have a significant vacancy rate then your rate may have to be higher for people who live in that facility. What you are telling me is that HUD is paying for units that it is not using?

Ms. SEVERIN. Now, they are all used. We are 100-percent occupied. I am saying if it were restructured we would have the vacancy problem because by attrition——

Mr. SHAYS. People die whether you have a tenant-based or voucher. So you have a vacancy. That issue exists under both scenarios.

Ms. SEVERIN. With the current scenario any old, frail, disabled person, particularly because——

Mr. SHAYS. Are you answering the question?

Ms. SEVERIN. Yes. Absolutely. With the current system that we now have that is project-based, a waiting list years long of frail, elderly, disabled people will come in and they get the subsidy because they are in the building and the building has a subsidy.

Mr. SHAYS. If someone has a voucher there is a vacancy and they move in.

Ms. SEVERIN. Yes. What happens when somebody comes in, if we were to be restructured and people had individual vouchers is that we do not believe that there would be enough vouchers to go around.

Mr. SHAYS. But the bottom line is we don't have a project base which converts the project into vouchers. That is a different fear. That is something different. That wasn't what you told me. You told me you had a vacancy rate. I want to make sure that we are focused in on the issue here.

Are you telling me that nonprofits are more expensive to operate?

Ms. SEVERIN. No.

Mr. SHAYS. Nonprofits didn't take out money in the beginning of a project. Are you telling me that the nonprofits like your own are getting more than the market rate?

Ms. SEVERIN. In this project they are and the reason is because they provide these vital support services that the residents have to have in order to maintain their independence. These are support services that would not be provided in the private market.

Mr. SHAYS. You say that in other places where they are paying more than market rate it is going to pay the mortgage. You are saying in this case it is going to pay for these services. That may ultimately be restructured to be more honest.

The honesty would be that if there is a service, let's note who is getting the service and who is paying for it, not necessarily that HUD should be paying for it out of housing. But what I hear you saying is, that you have basically used above-market rate to provide a whole host of very wonderful services. If yours is the facility I remember, there were one or two very beautiful facilities. You weren't the facility with the treadmills, were you?

Ms. SEVERIN. No.

Mr. SHAYS. I can laugh in one sense, but in another sense what I think is despicable is that people are paying the same rate as those who are getting the treadmills, but they are living in the facilities with the roaches. That is the one I have my problems with.

Ms. SEVERIN. This particular project is in an economically distressed neighborhood where the facilities around it, the comps, if there were comps, are inaccessible, a lot of absentee landlords, a lot of slums. But the seniors in that project provide a vital force as an economic development stronghold in the community, and as a nonprofit housing corporation concerned with the communities that the residents come from and live in, another one of our purposes is to maintain that housing as affordable—and we believe that the vacancy rate would increase—right now it is completely occupied, but we believe that the vacancy rate would increase if it went to private vouchers, individual subsidies.

Mr. SHAYS. Unfortunately, I thought I had a lot more time, but I am scheduled to be on live TV in a few minutes. I wonder if you could summarize. Based on the comments that I have made and the issues that we have been focusing on, if you could react to certain things that you heard and your bottom line point?

Ms. SEVERIN. I'd be happy to. One point which I didn't go into, because you were talking about who really pays for these services, this committee maybe has a different vantage point than another committee that we might speak to, is that Federal-assisted housing could play an important role in the whole long-term continuum for elderly people because it costs the Government a fraction of what it costs to put people into nursing homes or if they become homeless.

So now you keep them in their unit, we get some free nursing services from a local college, and the Government provides some resources through HHS or through another Department, so that you can keep people in housing and not be institutionalized.

To summarize, what we believe is that affordable housing if built and managed by community development corporations are different than they are for for-profit owners who have a profit motive. We would like to ensure the long-term affordability of the housing stock.

We believe that these special needs populations like the elderly will work best if we maintain a project-based assistance and we also are concerned that residents are not forced to pay more than they can afford in rents. And to allow nonprofit sponsors of housing programs financed under all these different projects like 236's to be considered the 202's, which we believe is most apt to be protected if any group is to be protected under the Mark to Market program.

Last, part of the problem with Mark to Market that we see for some of our populations is that the people that we are serving are already excluded from the rental market because of their income, age and frailty and disability, and that is why they live with us. We can provide services and a community to them they wouldn't have if they were just living out on their own, and that there will always be people in our society who are excluded from the market. Every Government and every country needs to care for these people——

Mr. SHAYS. You are just talking generically about how we have to care for poor people. There is really, that is not adding value to this hearing because we all agree that that has to happen. The issue is how do we deal, not whether we should. I hear your main point as being that nonprofits should be treated separately in any HUD plan to re-engineer.

Ms. SEVERIN. Right.

Mr. SHAYS. I agree with part of that in that I don't think that the nonprofits have the same issue of their wanting to buy out, so that we should be able to negotiate with them. I don't have any inherent problem with project base as a general rule. It is important for you to put that on the record. But we are trying to deal with the fact that we are paying over market and should we be paying over market?

The fact is that Congress is not going to pay over market. We are simply not. Whether I wanted to and I don't want to, my colleagues won't allow it. But I do agree with your basic point that the nonprofits give us an opportunity that we shouldn't lump everybody the same and say this is going to be the solution, that we have an opportunity with nonprofits to carve out and maybe deal with that problem sooner.

Ms. SEVERIN. The other point would be that certain populations like the elderly will never get a job and get on with their lives to get out of poverty, and so there are certain populations that need to be protected more than other populations.

Mr. SHAYS. I don't know if I agree with that, because I think a young child and a mother——

Ms. SEVERIN. Absolutely.

Mr. SHAYS. I think the elderly also can be less expensive, not more because I think they inherently have a better sense of how to keep and maintain a facility. They are not necessarily going to have the same challenges of kids.

While you can describe services you provide that cost more money, I will tell you that in some ways when we look at public housing they are the less expensive for us rather than more.

Ms. SEVERIN. Right. I also agree that children should be protected.

Mr. SHAYS. We have a lot of groups that need to be protected. Then you get to the disabled. Is there any last point you want to make?

Ms. SEVERIN. No. I am glad to have this opportunity. I wish you much luck and we would be glad to contribute in any way we can to the debate.

[The prepared statement of Ms. Severin follows:]

TESTIMONY OF

CAROL SEVERIN, BA, M. DIV.
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Representing
THE AMERICAN ASSOCIATION OF HOMES AND SERVICES FOR THE AGING

Mr. Chairman and members of the Human Resources and Intergovernmental Affairs Subcommittee of the House Government Reform and Oversight Committee. My name is Carol Severin. I am the President and Chief Executive Officer of Satellite Senior Homes, a not-for-profit development and management company of low-income elderly and disabled housing based in the San Francisco East Bay Area in California. Over the last three decades, Satellite Senior Homes has developed and manages 15 HUD-assisted facilities which serve approximately 1,200 very-low and low-income frail elderly and disabled persons. One of Satellite's projects is St. Andrew's Manor in Oakland, California, which is one of the ten case studies undertaken by the GAO to help Congress evaluate portfolio restructuring proposals. I am pleased to be here today representing the American Association of Homes and Services for the Aging (AAHSA), where I have served as a member of the Public Policy Committee.

I would also like to take this opportunity to commend the GAO on the honesty, integrity, and fairness with which they undertook the study. We were particularly impressed with the sensitivity and concern that they showed for Satellite's residents when visiting the facility. We are also pleased with the concern for our projects exhibited by senior staff in our local HUD office.

AAHSA is the largest national organization representing non-profit sponsors of senior housing. AAHSA members own and manage over 200,000 units of federally assisted housing and include the largest number of sponsors of HUD Section 202 elderly housing facilities, and non-profit sponsored Section 236, Section 231 and Section 221 (d)(3) elderly housing facilities. AAHSA is pleased to have this opportunity to present our comments on the very serious and troubling issue of restructuring the U.S. Department of Housing and Urban Development's (HUD) Section 8 portfolio.

In preparation of this testimony, a quick survey of our member database revealed that approximately one quarter of our members receiving Section 8 assistance would meet HUD's criteria for portfolio restructuring. We are particularly interested in contributing to the discussion on restructuring and its affect on non-profit owned facilities and residing residents. Since our member organizations are non-profits, whose Boards of Directors are comprised of volunteers representing religious-based, community organizations, and low-income residents, we have no profit or political motive in testifying other than to promote the well being of the population that we serve, and to maintain the financial viability of the facilities in which they live. Our concern about the portfolio restructuring is greatest for "special-needs" residents who require the service-enriched housing that many of our facilities offer, as those needs would not be met under this proposal.

We understand that Section 8 contract renewals place great stress on the HUD budget under the present system, and that the problem must be addressed. HUD has proposed a radical approach to problem -- originally called Mark to Market, currently modified to portfolio re-engineering or restructuring. We agree with the wisdom of addressing the very real threat to the financial soundness of the federal rental assistance programs. However, we believe that federally assisted non-profit housing is a distinct part of the portfolio restructuring equation that should be dealt with separately. We believe that our day-to-day experience in managing and owning projects serving the low-income, frail elderly and disabled as a non-profit organization can shed light on how portfolio restructuring will adversely affect our capacity to carry out our mission, and what this initiative would mean for residents in federally assisted facilities.

In this context, my testimony will focus on four major points:

I. A portrait of elderly residents in federally assisted elderly housing

II. The role of non-profits in providing elderly housing

III. The importance of project-based assistance for special needs populations

IV. The role of federally assisted housing in long-term care for the elderly

I. A Portrait of Elderly Residents in Federally Assisted Elderly Housing

HUD has earlier stated that Section 8 rental assistance is provided to nearly three million units of rental housing through its tenant and project-based programs. Yet, this level of assistance does not meet the desperate need for housing. A recent study by HUD shows that of 5.3 million households with worst case housing needs, where residents were spending more than 50% of their income on rent or living in severely substandard housing, almost 1.2 million, are headed by an elderly person.

> *"almost half (49 percent) of unassisted elderly renters with very low incomes have acute housing needs. Federal housing assistance reaches over one-third of households headed by eligible elderly, but another one third have unmet acute needs for housing assistance. Over two thirds of the elderly with acute housing needs have incomes below 30 percent of the median."*

Yet, the gap in affordable housing between need and supply is increasing. A recent study by the Center on Budget and Policy Priorities indicates that the shortage of affordable housing has reached 4.7 million units, the largest since the early 1970s. These very compelling issues of affordability and scarcity of supply are of particular concern to non-profit housing sponsors. Low and moderate income older persons have extremely limited options for safe, affordable housing, especially when considering that most are living on low fixed incomes.

In the rush to find a solution to the mounting Section 8 renewal problem, more consideration is needed to evaluate the impact of restructuring on residents and communities. It is critical that any restructuring proposal preserve long-term low-income rental housing affordability, and that it protect tenants from rent increases beyond their means and from homelessness. Vouchers do not automatically bestow protections to residents. In senior housing, vouchers ignore the value to the supportive services crucial to allowing seniors to avoid institutional settings for as long as possible and ignores the general lack of affordable housing. A wholesale changeover to tenant-based subsidies is a simplistic approach to a multi-faceted problem, to say nothing of its impact on the financial stability of a national asset: existing affordable housing.

The average income of residents in federally-assisted housing is around $8,000 a year, which is equivalent to only 18% of the Area Median Income across the nation. The seniors and disabled adults we serve are no exception. A portrait of the 1,200 residents who reside in our housing projects reveals a population that can no longer work, and will not get younger, or "weller", to pull themselves up by their bootstraps to get out of poverty. Many of our residents are in their 80s and 90s, some of whom are in wheelchairs or depend on walkers, and some are blind and deaf. Most have worked at very low wages all their lives and are now destitute, often forced to make the devastating choice between buying food or buying medicine after they pay their rent. There is a need for a clear recognition of the distinction between elderly (and other special populations) from family housing involved with portfolio restructuring . There are a number of obvious considerations such as fixed income, functional impairments and frailty due to increased age (e.g., the average age in many of our members facilities is now in the mid-80s) which affect both revenues (rent) and design features (e.g., elevators), and the need for facility services (coordinators, community space, services, etc.).

Recommendation:

We recommend that portfolio restructuring proposals consider the consequences for communities and residents, particularly for elderly and special-needs populations who do not have adequate housing alternatives in the marketplace.

II. The role of non-profits in providing affordable housing

During the last decade, the non-profit housing development industry has grown immensely in numbers and in capacity, and has become the most efficient and responsive affordable housing producer. For many non-profit housing organizations, production and management of low-income housing has been part of a larger community development strategy. These organizations are committed to addressing resident and community needs beyond housing, through providing social services or collaborating with other social services organizations. For the senior and disabled population, these services are critical for the residents to maintain productive, independent lives.

Non-profit housing organizations develop housing in order to maintain long-term housing affordability in the communities where they work. Non-profit housing organizations also respond to community needs, often working in economically distressed neighborhoods, developing solid, well-managed projects which contribute to community stability. This commitment to the wider community and long-term affordable housing is qualitatively different from profit-motivated owners, whose financial commitments to investors often lead to efforts to maximize profits and terminate the affordability regulatory agreements as soon as possible.

HUD's position on portfolio restructuring fails to deal with adverse tax consequences for for-profit owners of debt and rent writedowns. Transfer of ownership to non-profit sponsors prior to debt restructuring could be a strategy to resolve this problem, and should be included as part of any legislative proposal.

Recommendation:

When evaluating restructuring proposals, policy makers should carefully examine the quality of housing and services provided by non-profit organizations, and consider how this type of ownership could be expanded. As the terms of federal subsidies become less favorable, for-profit developers of subsidized housing will be increasingly interested in exiting the low-income housing field. Policy makers should design strategies to encourage non-profit acquisition of debt-restructured properties. In this age of government cut-backs, support must be given to the non-profit sector which has taken on the responsibility of assisting the government to care for the most impoverished groups in society.

III. The importance of retaining project-based subsidies for special needs populations

Much of the portfolio restructuring debate has centered around the HUD proposal to provide individual tenant vouchers, forsaking the project-based Section 8 contracts which support the projects. Although vouchers are an important component of federal housing policy, they can not be the only strategy to address housing need. In many highly concentrated urban areas, vouchers do not guarantee decent housing for residents. "Vouchering out" will not work in high-cost markets, where it is difficult to locate affordable units.

For well-managed properties that serve special-needs populations, it is critical that the federal subsidy remain project-based. Project-based subsidies are a federal commitment to long-term affordability of housing, and represent a solid place-based development strategy which provides social and economic stability for communities.

The loss of well-managed affordable projects in economically distressed neighborhoods would jeopardize community stability, and ignore the needs of long-term residents who would not wish to leave the area where they have lived and worked all of their lives. St. Andrew's Manor, one of the GAO case studies, is located in West Oakland, a neighborhood which has no comparable housing units offering accessibility, security, and services targeted for seniors and the disabled. West Oakland is an area that was built on and enjoyed thriving industry. It has suffered the mass exodus of the economic industrial base over the last twenty five years, which has thrown much of the region into economic distress. Much of the surrounding housing is sub-standard with fairly low rents and is unsafe. Seniors that qualify for HUD housing would still not be able to afford these rents. If St. Andrew's were unable to "compete" on the market without project-based subsidies, the neighborhood would loose a very important source of affordable housing for seniors. None of the "comparable housing facilities" examined by government-contracted appraisers were appropriate for the resident population served by our buildings. All of the government identified "comparable housing units" were small multi-storied buildings with no elevators. Most of the residents, due to frailty and disability, could not access a second floor apartment without an elevator, nor could they maneuver around an inaccessible studio with a wheelchair or walker. In addition, the "comparable housing units" lack effective security, and are otherwise not appropriate buildings for seniors.

St. Andrew's has on-site staff who administer the building, assess resident needs, and coordinate services for the residents. There is van service transportation to assist residents to shop and attend medical appointments, and the building has a security system. Most importantly for the residents, there is a sense of community within the building. Because of these amenities and the complete lack of "comparable housing units", we do not believe that the majority of residents would opt to leave if offered a Section 8 tenant voucher. Further, if they did, we know they wouldn't find comparable housing within their community.

Vacancies resulting after project restructuring is one of the key issues in projecting the adverse financial impact of taking away project-based subsidies. St. Andrew's, for example, is not atypical with a 25% yearly household turnover due to death, hospitalization, or residents moving to crowded conditions with family members to die in hospice. New vacancies in the building would be difficult to fill unless St. Andrew's were able to recruit new tenants with vouchers. However, new vouchers are scarce. With "market rents", St. Andrew's could not serve the same population that it currently does. Project-based subsidies are critical to maintain affordable and stable housing. According to the HUD-contracted Ernst & Young study, 26% of the projects evaluated would not "perform" under restructuring. According to our own financial analysis of Saint Andrew's Manor, the project would not be operable after only one year[1].

Government-contracted reports suggest that the building is not being used at its "highest and best use" from a real estate perspective. If St. Andrew's is not the appropriate facility for frail elderly, what would happen to the community that it serves? The majority of our residents know

[1] See *"Mark to Market Initiative: Implications for St. Andrew's Manor"* prepared by Satellite Senior Homes, 1995

from life-long experience that in a for-profit competitive market, they face severe discrimination based on age, disability, frailty, race, source of income, and accommodation needs. A private landlord would have no incentive to rent to these tenants above others. Furthermore, private market buildings do not meet the residents' needs.

Recommendation:
We recommend that portfolio restructuring retain project-based assistance for non-profit owned housing; and in determining market-rate rent levels, portfolio restructuring should allow for increased operating costs for the provision of services in elderly and special-needs housing facilities.

IV. The role of federally assisted housing in long-term care for the elderly
Federally assisted elderly housing plays an important role in long-term care of this nation's elderly. It has been documented that elderly persons prefer to remain in their own communities, homes or home-like environments as long as possible. To make this possible, non-profit elderly housing sponsors provide supportive services to frail elderly residents aging-in-place. Elderly housing is a critical link in the integrated delivery system strengthening the linkage with long-term care, promoting home-like service delivery environments, and promoting cost-effectiveness. Our members do not simply provide a physical living environment for the residents that we serve but they also provide services and linkages to the support systems necessary to enable their residents to live independently within their communities safely and with dignity. As an organization, AAHSA is unique in representing non-profit sponsors involved in the entire spectrum of retirement facilities, including housing, assisted living, community services, and nursing homes. Our members have extensive experience with the care of frail elderly in various residential settings.

The elderly, disabled, and other special-needs populations require services to avoid costly institutionalization or homelessness. By comparison, these subsidies are much less than federal subsidies invested in other types of institutions, such as federally funded nursing homes. Past studies have suggested a significant cost savings per unit for supportive housing compared to nursing homes. Though nursing homes provide an important service and are vitally necessary for certain frail older persons, most experts recognize that institutional-based solutions to long-term care problems are often over utilized because alternative housing options are unavailable. The dramatic movement of managed care organizations into long term care is reflective of the future trend of serving seniors and other vulnerable persons in the most cost-effective setting possible, e.g., senior housing.

The 1990 Housing Act "de-linked" the Section 202 program from Section 8 as part of a major restructuring of the Section 202, by replacing it with a capital grant and Project Rental Assistance Program (PRAC). Congress recognized that it was a more cost effective approach to provide an "up front" grant for development costs, and provide a rent subsidy. As most AAHSA members will attest, the revised Section 202/PRAC program works very well. Many non-profits participated in such FHA programs as Section 236 and Section 221(d)(3), because the Section 202/PRAC was not in existence.

Recommendation:

It is our belief that regardless of federal funding source--whether developed under the Section 202, Section 236, Section 221(d), Section 231, or others--non-profit sponsored housing that is designed and operated specifically for the elderly, should be treated similarly because of the mission-oriented commitment of the sponsors, the commitment to affordability for the residents, and the commitment of the non-profit sponsors to the long-term care of the residents. We recommend that nonprofit sponsors of elderly housing be give the option to convert their existing FHA/Section 8 program into the Section 202/PRAC. We believe that the Section 202/PRAC program, as revised, will provide opportunities for mixed-financed, mixed-income, and mixed-use (housing with assisted living, health clinics, and/or other services/business marketing to older residents).

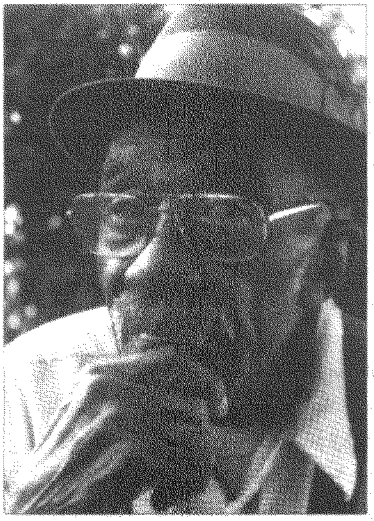
Conclusion

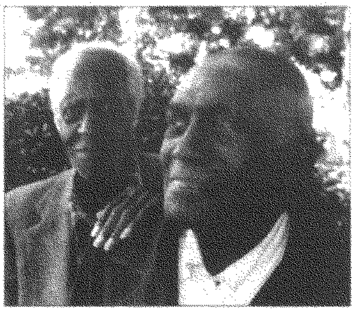
Thank you for this opportunity to share some concerns of the non-profit housing industry about the restructuring proposals. The current system of Section 8 project-based contract renewals as we know it will undoubtedly change. It is critical that protections be put in place to ensure long-term affordability of housing stock, that project-based assistance be continued for well-managed properties, that residents not be forced to pay more than they can afford in rents, and that critical social services which are included in special-needs housing be supported. Non-profit organizations have played an increasingly important role in affordable housing provision and in community development. With their experience and mission, non-profits should be included in the overall strategy to transform federally assisted housing. The expiring Section 8 contract crisis comes in part from the short-sighted housing policy of the past. We should not recreate short-sighted policy which balances the federal budget at the expense of the poorest and most vulnerable people of this country. If you have any additional questions, I will be happy to answer them.

RESIDENTS,
FRIENDS

SAINT ANDREW'S MANOR
SATELLITE SENIOR HOMES

OAKLAND, CALIFORNIA





Prepared by Satellite Senior Homes
December, 1995

Mark to Market Initiative
Implications for St. Andrew's Manor

Mark to Market is a proposal to financially restructure Federally assisted housing to lessen or remove Federal housing subsidies, and to introduce this housing stock to the "efficiencies" of the market place. One of the principal goals of the initiative is to restructure FHA insured debts to levels that can be supported by "market rents", in order to phase out project-based Section 8 assistance. Section 8-like vouchers, that residents can take with them if they move, are promised to accompany such an initiative to not jeopardize residents' immediate access to housing in the transition period. Projects in the Mark to Market model include Section 236 with LMSA, Section 8 NC/SR, other FHA insured with LMSA and Section 8 PD.

Several of Satellite's buildings are federally insured 236s which fall into this category. Four of Satellite's buildings are among the 500 federally subsidized projects randomly selected to be part of a national survey to analyze the impact of Mark to Market. St. Andrew's is one of 10 properties out of the 500 which was selected to be part of a more in-depth case study analysis to present the Mark to Market model to Congress. In this capacity, St. Andrew's has been subject to multiple visits from HUD-paid consultants, two visits from GAO officials, a real estate appraisal, and a day of videotaping. As Mark to Market is in its design phase, diverse options are being considered, and no single scenario can be projected at this point. However, St. Andrew's financial structuring, resident population and neighborhood indicate that such an initiative has bleak implications for the building and its community.

Under the Mark to Market proposal, Section 8 project-based assistance will not be renewed as contracts expire. St. Andrew's has two Section 8 project-based assistance contracts: A contract for 37 units expires in August, 1996, and a contract for 22 units expires in May, 1998. All residents would be offered vouchers which they could take with them if they decided to move. How long these private vouchers would be good for, however, is not clear. This issue is critical since one of the main objectives of the initiative is to reduce Section 8 costs.

A substantial number of mortgages in the Mark to Market portfolio are anticipated to default after Section 8 assistance payments stop. Authors of the initiative say that debt restructuring, possibly including a waiver of the mortgage, would occur for "good properties"

However, properties that could not survive on the market without continued project-based Section 8 subsidies would be sold off in "reflector sales" or mortgage partnerships. If no appropriate buyer emerged, the buildings would be demolished.

St. Andrew's receives two types of subsidies from HUD. First, HUD pays 6% of the interest on the mortgage, and Satellite only pays 1% of the interest. Second, the project-based Section 8 contracts provide a large subsidy for the building. For example, in November, 1995, residents paid $11,699 in tenant rents, while HUD paid $23,303 to Satellite to subsidize their rents. While the initiative contemplates various ways of restructuring the mortgage, it aims to completely take away the project-based Section 8 subsidy.

Because of all of the services that are offered at St. Andrew's and the sense of community at the building, we do not suspect that the majority of residents would opt to leave if offered a Section 8 tenant voucher. St. Andrew's offers a level of services and accessibility that could not be found in the private for-profit sector. It also provides a level of safety that could not be matched were the resident living on his or her own. For example, the GAO took Satellite staff to see a "comparable unit" in the same neighborhood. It was a two story duplex with no access for frail or disabled residents. There are no "comps" in the neighborhood. Additionally, many residents have long-term roots and family in that neighborhood and would not want to be leave. Still, other residents know from experience that they would face racial, age, disability and frailty discrimination if they tried to take tenant Section 8 vouchers elsewhere. The nature of elderly housing is to have a higher turn-over rate than family housing. St. Andrew's has a yearly resident move-out rate of around 25% due to illnesses, move-outs to nursing homes, and deaths.[12] We project that when a unit becomes vacant due to these various reasons, it would be increasingly difficult to fill if St. Andrew's did not have project-based Section 8 assistance.

The following spreadsheets present some of the different Mark to Market scenarios for St. Andrew's. Appendix 1 presents projected finances for St. Andrew's with "Fair Market Rents" (FMRs) as determined by Housing Authorities with current revenues and expenses. The

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[1] Based on our statistics from Leasing and Occupancy. For the year November 1994 - November 1995, St. Andrew's had an average vacancy rate of 7%. 25% of the units had move-outs and 30% of the units had move-ins. This difference is due to an aggressive lease-up effort in recent months, bringing the vacancy rate down to 3% in the last two months. Statistics from the previous year, November 1993 to November 1994, showed a slightly higher "move-out" rate; 27% of units had move-outs and 15% of units had move-ins.

FMRs are less than current contract rents for St. Andrew's. Assuming mortgage payments went unchanged, if St. Andrew's received FMRs for every resident, it would have a monthly shortfall of $4,004. If no mortgage payments had to be paid, the monthly shortfall would fall to $1,513. The FMR rate is significant because it is the maximum rent currently subsidized by HUD with Section 8 tenant vouchers. These figures assume that the building would be leased up with all Section 8 vouchers with only a 5% vacancy rate.

Appendices 2 A & B illustrate the "worst case" scenario in which "market rents" are determined as those which would support full debt service and operating costs with no mortgage interest subsidy *or* Section 8 project-based contracts. The one-bedrooms and studios have been merged into one unit with an average rent for simplicity's sake. The "market rent" would be $675 for this studio/1 bdrm. unit to fully support the building's debt service and operating costs. We calculated a ten year cash flow with these rents and certain assumptions regarding the vacancy rate. With a monthly rent of $675, the project would have a positive cash flow in Year 1 of $3. However, under certain vacancy assumptions, the cash flow fall to negative $99,167 by Year 2. By Year 3, the building's debt would escalate to $183,646.

A more favorable scenario is illustrated in Appendices 3 A & B, under which "market rents" are calculated as rents which would support operating costs with no mortgage payment (i.e. HUD would take away the project-based Section 8 subsidy, but would continue to pay the interest on the mortgage and would forgive our part of the mortgage payment). However, these "market rents" would still be quite high at $566 for the studio/one bedroom unit. The cash flow analysis shows that the building, with its current operating expenses, would go bankrupt by Year 2 under either of these "market" scenarios.

The "vacancy question" is one of the major issues in trying to assess the financial impact of taking away project-based Section 8 subsidies. St. Andrew's is located in a declining neighborhood in Oakland. We estimate that rents in the area for a studio or one-bedroom average between $350 - $550 for a comparably-sized unit, far below the St. Andrew's "market rent" of $675. As services are cut back due to declining revenues, the vacancy rate would grow. To illustrate the potential consequences, we calculated the vacancy rate at 5% the first year (which falls between the current vacancy rate and the average for the last year). By year two there would be a 25% move-out rate, and those vacancies would be difficult to fill unless

St. Andrew's succeeded in recruiting new tenants with vouchers. Optimistically, if St. Andrew's were able to fill 5% of those vacant units with new Section 8 voucher holders, the building would have a vacancy rate of 24% in Year 2. Under the assumption that Year Three also had a 25% turnover and 5% lease-up with voucher holders, the vacancy rate would grow to 39% (see Appendix 4, the vacancy rate calculation).

Perhaps a more useful way to look at these scenarios is to analyze how the revenues would decline given our projected vacancy rates Appendix 4, the vacancy rate calculation, illustrates that by Year 2 there would be a loss of revenues of $85,298. With this loss, the Service Coordinator and other staff positions would have to be eliminated entirely. Year 3 would have a further loss of $72,147 The Retirement Home Manager, the Van Service and Maintenance could no longer offer services to the building. St. Andrew's could no longer exist as a building which offers community services to seniors and would soon fall into disrepair.

It is clear that under any of these scenarios, the Mark to Market initiative would have a drastic impact on St. Andrew's and its residents Although we do not project that the majority of residents would leave the building if given a private Section 8 voucher, it would be very difficult to fill units as they became vacant with market rents. We would have to locate the few lucky individuals with Section 8 vouchers to maintain occupancy, and the majority of low-income seniors without vouchers could not afford to live there. St. Andrew's currently serves a marginalized community of very-low income seniors and disabled adults, with an average income of $692 a month. "Market Rents" from between $566 to $675 (depending on the financial restructuring of the mortgage) could not possibly serve this same community once units became available The level of services at St Andrew's, which offers this community access to transportation and community services, would have to be cut back drastically or eliminated completely within the first year of the transition to cover the growing deficit of building operations. In short, Mark to Market presents only no-win scenarios for the community of very-low income seniors and disabled adults that St Andrew's currently serves.

Mark to Market ST. ANDREWS

I. Projected Finances with Rents = Fair Market Rents (FMR) as defined by Housing Authorities

Appendix 1

Note: These projections assume a constant 5% vacancy rate, which is unlikely given the 25% apartment turnover rate at St. Andrew's.

Rev Rents

Type of unit	*# of units*	*FMR*	*Rental Revenue*
Eff. Studio	42	$530	$22,260
Jumbo Studio	9	$530	$4,770
1 bd	8	$642	$5,136
Totals:	59		$32,166
Loss due to Vacancy Rate of 5%			($1,608)
Rent Revenues:			$30,558
Other revenues (based on current)			$350
Total Revenues:			$30,908

Expenses

Monthly Operating Budget:	$34,562
Shortfall	($4,004)

With No Debt Service

Monthly Operating Budget assuming no debt service (monthly mortgage payment is $2,491.14)	$32,071
Shortfall	($1,513)

II. Calculation of "Market Rents" (defined as those rents which would cover debt service and expenses with no mortgage subsidy)

Appendix 2A

Note: No one could afford the $675 "market rent" unless they had a Section 8 voucher. This "market rent" is above the current FMR.

Revenues			
Rents			
Average between	units		
1 bdrms and studios:	59	**$675**	$39,835
Less 5% Vacancy			($1,992)
Total Rent Revenues:			$37,843
Other Revenues from Coin Operated Laundry (based on current)			$350
Total Monthly Revenues:			**$38,193**
Expenses			
Current Monthly Operating Budget			$34,562
Pmt. of currently subsidized part of mortgage interest (6%)			$3,631
Total Monthly Expenses:			**$38,193**

note (1 bdrm is 1.21 times cost of studio)

"Market Rents" with
no subsidies

II. "Market Market Scenario" - How St. Andrew's would fare over time if rents were raised to level which would support operating costs and full debt service with no mortgage subsidy.

INCOME		Tenant	Total	Total Yrly.	Total Annual
Type of units:	# of units	"Market Rent"	Monthly Inc.	Rental Inc.	Rental Inc
1bd/studios	59	$675	$39,835	$478,020	
Laundry Revenues			$350	$4,200	$482,220

EXPENSES		FIRST YEAR CASH FLOW	
Monthly operating budget	$34,562	Gross Income from tenants	$482,220
Monthly subsidized part		LESS vacancy (5%)	$23,901
of mortgage (6%)	$3,631	EFFECTIVE GROSS INC.	$458,319
Total Expenses	$38,193	LESS operating expenses	$458,316
Yearly Expenses	$458,316	Cash Flow	$3

TEN YEAR CASH FLOW
Assumptions: Rents increase 3% a year Operating Expenses increase 4% a year
Vacancy rate assumption: 25% turnover with 5% of vacant units filled with vouchers per year. As residents move out, "market rent" is too high to attract other residents who can afford market rents.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Gross Income	$482,220	$496,687	$511,588	$526,935	$542,743	$559,026	$575,796	$593,070	$610,862	$629,188
Less Vacancy	$23,901	$119,205	$199,519	$268,737	$331,073	$385,728	$431,847	$474,456	$513,124	$547,394
Effective Gross Income	$458,319	$377,482	$312,068	$258,198	$211,670	$173,298	$143,949	$118,614	$97,738	$81,794
Less Operating Expenses	$458,316	$476,649	$495,715	$515,543	$536,165	$557,611	$579,916	$603,113	$627,237	$652,327
Cash Flow	$3	($99,167)	($183,646)	($257,345)	($324,495)	($384,314)	($435,967)	($484,499)	($529,499)	($570,532)

III. Calculation of "Market Rents" which would cover expenses assuming no debt service

Appendix 3A

Note: Few people could afford the $566 "market rent" unless they had a Section 8 voucher.
This "market rent" is above the current FMR.

Monthly Revenues

Rents			
Average between	Units		
1 bdrms and studios:	59	**$566**	$33,391
	Less 5% Vacancy		($1,670)
	Rent Revenues:		$31,721
	Other Revenues (based on current)		$350
	Total Revenues:		**$32,071**

Monthly Expenses

Monthly Operating Budget assuming no debt service	**$32,071**

note: (1 bdrm is 1.21 times cost of studio)

"Market Rents"
with
mortgage subsidy

III. Market Scenario with debt service - How St. Andrew's would fare over time with "Market rents" which would support operating costs with no mortgage payment

INCOME		Tenant	Total	Total	Total
Type:	Quantity:	Rent:	Monthly Inc.	Yrly Rent:	Annual Income:
1bd/studios	59	$566	$33,391	$400,692	
Laundry			$350	$4,200	$404,892

EXPENSES		FIRST YEAR CASH FLOW	
Monthly operating budget	$32,071	Gross Inc. from tenants	$404,892
Assuming no debt service		LESS vacancy (5%)	$20,035
		EFFECTIVE GROSS INC.	$384,857
Total Expenses	$32,071	LESS operating expenses	$384,852
Yearly Expenses	$384,852	Cash Flow	$5

TEN YEAR CASH FLOW
Assumptions:Rents incresase 3% / yr. Operating expenses increase 4% / yr.
Vacancy rate assumption: 25% turnover with 5% of vacant units filled with residents with vouchers per year
As residents move out, "market rent" is too high to attract other residents who can afford market rents

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Gross Income	$404,892	$417,039	$429,550	$442,436	$455,709	$469,381	$483,462	$497,966	$512,905	$528,292
Less Vacancy	$20,035	$100,089	$167,524	$225,643	$277,983	$323,873	$362,597	$398,373	$430,840	$459,614
Effective Gross Income	$384,857	$316,949	$262,025	$216,794	$177,727	$145,508	$120,866	$99,593	$82,065	$68,678
Less Operating Expenses	$384,852	$400,246	$416,256	$432,906	$450,222	$468,231	$486,961	$506,439	$526,697	$547,764
Cash Flow	$5	($83,297)	($154,231)	($216,112)	($272,496)	($322,723)	($366,095)	($406,846)	($444,632)	($479,086)

Vacancy Rate Calcuation
St. Andrew's

		59 total units			
	# of occupied units	Vacy. Rate	Org resid.	FMR Vchs.	Revenues
Year 1	56	5%	56	0	$419,666
Year 2	45	24%	42	3	$334,368
Year 3	36	39%	32	4	$262,221
Year 4	29	51%	24	5	$209,746
Year 5	23	61%	18	5	$165,484
Year 6	18	69%	13	5	$132,288
Year 7	15	75%	10	5	$107,391
Year 8	12	80%	7	5	$88,718
Year 9	9	84%	6	3	$61,634
Year 10	8	87%	4	4	$57,670

Notes: Vacancy rate assumption: 25% turnover with 5% of vacant units filled with FMR vouchers per year.

Number of occupied units is rounded to nearest whole number.

Mr. SHAYS. You are contributing. One of the notes I made to my staff director is that I would like Secretary Cisneros to kind of call a group of former administration people and present from both parties and administrations past, and some Members of Congress and we should go away for a few days and bring in people from maybe the private sector as well as nonprofit to brainstorm and then to bring in some of the foundations that have been working on this. I think we have to be willing to interact in that way.

I am going to call the hearing to a conclusion and thank all of our witnesses. I am sorry I am pressing you a little bit. I didn't manage my time as well as I realize I should have. Thank you. This hearing is closed.

[Whereupon, at 1:05 p.m., the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:]

Mr. Chairman and Members of the House Subcommittee on Human Resources and Intergovernmental Relations:

Thank you for the invitation to submit this statement on management of the government's portfolio of billions of dollars of mortgage insurance on properties that also receive federal rental assistance. My name is Thomas H. Stanton. I am a Washington, DC attorney who specializes in the design and administration of federal programs, and especially federal credit programs. My publications on federal credit programs and financial institutions and markets include a book and a number of articles. My statement relates to research that I conducted for the federal government with respect to the insured and assisted multifamily loan portfolio.

I am a fellow of the Center for the Study of American Government at Johns Hopkins University, where I teach on the law of public institutions, and am a member of the Advisory Board of a professional journal, The Financier: Analyses of Capital and Money Market Transactions. In this statement I will be speaking only for myself and not for any institution, client or university with which I am affiliated.

This committee is to be commended for holding this hearing on ways to extract ourselves from the financially troubled multifamily housing subsidy program. The government is unlikely to be able to continue to afford today's system of payment of above-market rents on hundreds of thousands of housing units. Effective actions in anticipation of the transformation of those units to a market-based system could help to cushion the impact for tenants, owners and taxpayers.

In my statement I would like to make three points:

(1) The Department of Housing and Urban Development (HUD) does not have adequate capacity to supervise its insured and assisted multifamily portfolio today.

(2) To extricate ourselves from the troubled portfolio will require even more capacity, applied intensively over a few years, than is required today.

(3) Private partners can be of great help in implementing a solution. However, they must have both capacity and incentives that are aligned with those of the government; otherwise HUD will find itself once again in the plight of today, where it lacks the capacity to supervise partners who have incentives to depart from the public purposes that the program is supposed to serve.

As this subcommittee knows from its earlier work, institutional capacity is a serious problem for HUD in its administration of the multifamily portfolio. Any resolution must include private partners who are capable of augmenting that capacity.

Perhaps new to the subcommittee is the record of the Resolution Trust Corporation (RTC) in helping to minimize the long term impact of the savings and loan debacle. As the experience of the RTC showed, there is a clear tradeoff between the incentives of private parties who participate in government programs and the institutional capacity that the government requires for effective supervision of those parties.

The RTC was able to design and implement ways of dealing with real estate assets that used private partners very effectively. While HUD's mission is different from that of the RTC, the RTC experience can help the Congress and executive branch policymakers to design approaches for the HUD assisted and insured multifamily portfolio.

There is increased recognition that the federal government should address the issue of above-market rental subsidy payments before rather than after the Section 8 contracts expire. Such preemptive steps can help to recognize the potential win-win among today's tenants, property owners and managers, and taxpayers. If above-market rental subsidies simply expire, then tenants could face precipitous loss of their apartment units, owners could face recapture of substantial tax benefits, and -- of special relevance to this hearing -- the government's institutional capacity will be stressed in unprecedented ways. Consider each of the issues in turn.

I. <u>HUD's Institutional Capacity Today</u>

Institutional capacity is essential for a government agency such as the Department of Housing and Urban Development to oversee its portfolio of billions of dollars of multifamily mortgage insurance. Assisted multifamily projects with HUD-insured mortgages present a special set of problems.

HUD's current capacity to manage its portfolio of insured mortgages is limited. Shortcomings in information and systems, limitations upon staff and contractor support, restrictions upon available tools for effective loan administration, and a complicated institutional culture all combine to impede even the most talented and motivated people at HUD from doing their jobs as effective asset managers.

Figure 1 (on p. 4 of this testimony) presents the elements of institutional capacity that are required for HUD to manage its multifamily mortgage insurance effectively: (1) high quality information and information systems, (2) capable staff, either in-house or through contractors, (3) authority to act as a prudent manager, and (4) an institutional culture that encourages effective financial management. My research, conducted earlier this year, applied these criteria first to HUD's Special Workout Assistance Team (SWAT) program and then to HUD's administration of its entire portfolio of multifamily assisted and insured properties.

The research concluded that, indeed, institutional capacity is a serious problem for HUD in its administration of today's multifamily portfolio. The success of the SWAT Team stands as a striking contrast by virtually all of the measures in Figure 1. Consider each of the four elements in turn.

High quality information and systems: By contrast to the SWAT Team, HUD multifamily asset managers/loan servicers in the field offices lack access to a central database with accurate and timely information about the entire HUD portfolio. The department also lacks good central information about staffing and caseloads of asset managers/loan servicers in each field office.

Capable staff and contractor support: The SWAT Team selects its staff from among volunteers, on the basis of relevant skills and ability to work with people. A SWAT contractor trains SWAT members in their tasks and in use of the new management information system. By contrast, asset managers at HUD field offices are of variable quality. Hiring freezes have created an aging workforce.

SWAT field representatives each oversee a much lower caseload than is found elsewhere at HUD. Each SWAT member may be responsible for a portfolio of about ten projects. This compares to HUD portfolios that can range to over 100 projects per asset manager at a large city office such as Detroit, and down to perhaps 35-40 at a field office such as Greensboro. The average HUD caseloads are significantly greater than those of state agencies in Michigan or Pennsylvania, that have comparable multifamily portfolios.

SWAT Teams are backed by contractors, including accounting, appraisal, inspection and legal support. Both the HUD Office of General Counsel and a section of the Department of Justice have reorganized to provide strong legal support to SWAT matters and enforcement actions. Finally, the SWAT effort is backed by sufficient budgeted funds, at least for the current limited caseload. This includes money for travel, training, contractors, computers and information systems.

Figure 1

The Elements of Institutional Capacity to Manage the FHA Multifamily Mortgage Portfolio

I. Capacity to Know the Condition of the Portfolio

- Quality Information (relevant, accurate, timely)
- Information Systems

II. Staff Capacity

- Staff With Skills to Use Information Effectively
- Reasonable Workload to Permit Staff Attention to Individual Properties
- Flexibility to Deploy Staff to Meet Needs of Portfolio Management
- Ability to Retain Needed Contractor Support

III. Capacity to Act Effectively

- Legal Authority to Address Problems Effectively
- Ability to Make Decisions Promptly
- Authority to Manage Incentives of Mortgagees/Owners/Managers (Without Interference or Pressure to Forebear)

IV. Institutional Culture

- An Institutional Culture That Provides Clear Guidance With Respect to the Tension Between Doing Well and Doing Good
- Institutional Culture That Encourages Effective Portfolio Management

Capacity to act effectively: The SWAT effort recognizes the limitations of the design of the multifamily programs and uses enhanced information and legal support to maximize the application of the available tools. Perhaps most importantly, the SWAT Team operates under a directive that does not discourage assignment of a mortgage or foreclosure on a property in appropriate cases. The SWAT structure is also designed to enhance the ability of field staff to respond quickly. This contrasts with the traditional HUD structure that requires a multilayer review of requests within a field office and subsequent layered reviews in Washington.

Institutional culture: The SWAT Team has taken steps to create a new institutional culture. The staff operates according to a fixed protocol: assess the property, screen it, assign it for action, negotiate and enforce if necessary. This is a profoundly different environment than is available to asset managers in the more overworked HUD offices where the absence of clear financial objectives, and of sufficient staff with appropriate expertise in financial management, have led to an institutional culture that does not reward active financial management.

The SWAT effort demonstrates that HUD can deploy its capacity effectively to deal with parts of the multifamily portfolio. The problem, of course, is that the SWAT Team can only deal with a few hundred properties, out of 15,000 properties with mortgage insurance that HUD must supervise. The department is now working to supply added resources to the field offices as well. A new procurement for millions of dollars of contractor support is expected to give the department the capacity to obtain needed financial reports, physical inspections and other information about perhaps a thousand of the more troubled projects. Yet, even these added resources do not suffice to deal with possibly (no one knows) several thousand such properties that currently require such attention.

II. HUD's Capacity to Manage the Resolution of Today's Insured Projects That Receive Above-Market Rental Assistance

To extricate ourselves from the troubled portfolio will require even more capacity than is needed for today's supervision alone. A reduction in the budgeted resources for above-market levels of Section 8 rental assistance would be likely to drive many projects into default.

The recent Ernst & Young Kenneth Leventhal study found that after such a reduction in rent subsidies, only about one-fifth of the properties could meet operating expenses, capital needs and debt service on their current mortgages. Slightly over half of the mortgages would need restructuring to keep the property viable, and about a quarter could not meet capital expenses and operating needs even if the mortgage were written down to zero.

Substantial capacity will be needed to deal with the decisions that must be made with respect to these thousands of properties. Consider again the four elements of institutional capacity.

High quality information and systems: If HUD were required to deal with each property individually, then the department would need to assure access to careful appraisals and high-quality determinations of the potential of each property to generate income under various possible scenarios.

Necessary information might include (1) appraisal of the fair market value of the property, determined without regard to current Section 8 project-based assistance, (2) projection of rents that the property could charge if their level were determined by the market rather than by government formula, (3) estimates of the size of mortgage that could be supported by market-level rents, if these are below current project-based Section 8 rent levels, (4) analysis and inspection to ascertain the extent that the property needs capital improvements to be viable in the market without project-based Section 8 assistance, and (5) analysis of the extent that the property would be viable if Section 8 certificates or vouchers were available (first to current tenants and, after a transition period, generally in the market).

Capable staff and contractor support: Demands upon staff also would increase considerably. Depending upon the extent of the reductions in rental assistance, the number of troubled properties and the need to negotiate possible workouts could increase significantly.

If required to deal with properties individually, HUD staff and contractors would need to assess the quality of the appraisal and the determination of income potential of each property. HUD staff would also need the capacity to make careful judgments about the extent that additional federal resources, e.g. in the form of capital grants, capital improvements or additional rental assistance, possibly through vouchers or certificates to tenants, would make the difference in the extent that each property would be financially viable over the remaining life of its federally insured mortgage.

Capacity to act effectively: Issues of capacity here include both the legal authority to respond promptly and properly, and also the empowerment of professionals to make timely decisions and obtain prompt resolution of outstanding issues from the organizational hierarchy.

HUD field staff would need authority and budgeted resources (1) to hire property managers and other contractors promptly, e.g. to ascertain the condition and viability of the property, (2) to enter into negotiations with current owners for a workout, (3) to hire experienced negotiators with skills to supplement those in house at HUD, (4) to require risk sharing in workouts to create incentives of borrowers and mortgagees to act in a manner that protects the government's financial interests, and (5) to commit additional resources that may be needed to protect the property or to facilitate a workout, e.g. to provide a "soft" second mortgage as a way of protecting the owner against adverse tax consequences.

If a property goes into default, HUD must have the authority to act quickly to protect both the condition of the property and the interests of tenants. HUD must have authority to deal both with the mortgage, preferably without a formal foreclosure, and possibly with the disposition of the property itself.

Institutional Culture: If the Congress decides to permit expiration or significant reduction in the levels of some or all Section 8 project-based assistance, then the tension between doing well and doing good could inject itself into a large number of decisions. The Congress could reserve a number of these decisions for itself. If not, then HUD may need to decide whether, or on what conditions, to let property owners prepay their HUD-insured mortgages, whether to protect certain kinds of tenants (e.g. the elderly? the disabled? large families?) from the need to move from their current assisted project, and how to allocate scarce resources for property improvements, tenant counseling and other important purposes.

One important statutory issue will involve the intended outcome of portfolio restructuring. HUD's institutional capacity was weakened from the inception of the program of providing rental assistance to properties that had been financed with HUD-insured mortgages. The result of the combination of mortgage insurance and rental assistance was to confuse thoroughly the perceived roles of the responsible HUD staff. HUD asset managers came to see their role as one of helping tenants and avoiding insurance claims by finding additional sources of subsidy if necessary. This made it virtually impossible for them to impose the financial discipline upon owners and mortgagees that an insurer such as HUD must have if it is to protect taxpayers from the prospect of intolerable losses.

It will be important to avoid replicating this confusion of roles in the restructured properties. HUD's capacity to oversee properties even after restructuring could be sorely tested if these properties once again involve an uncontrolled combination of federal rental assistance and federal mortgage insurance.

In summary, if the process is not well designed beforehand, the expiration of current levels of Section 8 rental assistance on properties with HUD-insured mortgages has the potential to impose virtually intolerable demands upon HUD's already strained institutional capacity. In particular, the Congress will need to structure the process of portfolio resolution so that HUD can utilize private partners whose incentives are so well aligned with those of the government that supervisory burdens upon HUD do not become unsustainable.

III. Lessons About Capacity and Incentives From the Experience of the Resolution Trust Corporation (RTC)

The experience of the federal government in dealing with the consequences of the savings and loan debacle provides some valuable lessons about the tradeoff between the government's capacity and the incentives of private parties. The lessons from that experience are relevant to the administration of federal credit programs generally and to the HUD multifamily insurance programs in particular.

Perhaps the most important lesson of the government's experience with the thrift debacle is that federal budget constraints can reinforce a general reluctance to take active steps to recognize program losses. The costs of such inaction to taxpayers can be very expensive, despite the efforts of program officials to work around legal and budget impediments through use of complicated institutional structures.

Another important lesson from this experience is that sound design of a program or process can greatly reduce the institutional demands upon a federal agency. When the RTC attempted to supervise asset managers, this imposed great demands upon the government's institutional capacity. Moreover, government officials often were tempted to substitute their own judgments for those of the private asset managers.

By contrast, when the RTC developed securitization or joint-venture approaches, these could be structured to reduce demands upon the government's own resources. The RTC entered into contracts with private partners that helped create a win-win outcome: the private partners could make money, but only when they acted to promote the government's interests as well; the RTC's securitization and joint-venture structures were able to align incentives between the private partners and the government, compared to the need to oversee and control individual asset managers. The contracts also helped to protect the private partners from long deliberations of government officials who might have been tempted to second-guess any of a myriad of decisions.

The RTC experimented with a number of approaches to asset disposition. Consider the difference between (1) placing assets into the hands of private contractors under a "Standard Asset Management and Disposition Agreement" ("SAMDA"), and (2) use of joint-venture partnerships.

Contractors: The RTC used over 100 so-called "SAMDA" contractors, and some 2,000 subcontractors, under three year agreements to manage and dispose of some $40 billion of assets through individual asset sales, workouts and settlements. These contractors and subcontractors received fees both for managing and disposing of properties. Their incentives did not necessarily coincide with the mission of the RTC.

RTC officials found that it was difficult to structure sufficiently strong and clear incentives for each of the private contractors. Fear of possible financial abuses meant that the RTC could not delegate asset management and disposition decisions freely to contractors. Supervision of SAMDA contractors and approval and supervision of their activities imposed significant burdens upon RTC in-house staff.

Joint-venture partnerships: The RTC developed joint-venture partnerships as a larger-scale way to deal with many of the more troubled assets, including multifamily and commercial properties and mortgages. The joint venture partnerships provided for risk-sharing between the government and the private party in the form of equity sharing. The winning qualified bidder became the general partner and holder of a specified equity interest in the partnership.

The winning bidder was compensated primarily through its share of returns from the sale of assets or income from assets. The RTC was the limited partner with the right to receive a stated percentage of cash flows. The RTC developed contract terms to prohibit self-dealing and exceptional tax benefits and that helped to align the interests of the private joint venture partner with those of the government.

The joint venture partnership thus assured the private partner a significant share of net cash flows, but removed other interests of the private partner that could complicate the incentive structure. The RTC joint-venture partnerships were successful financially for the RTC, were easy to monitor and imposed minimal burdens upon the institutional capacity of the agency.

For example, in two particular joint-venture partnerships known as the "AMDA" partnerships, the RTC employed three people part-time, amounting to about one full-time equivalent (FTE) person on staff, to oversee some $3-4 billion of assets. The proceeds of the transactions were used to hire one accounting firm per partnership to monitor that the private partners lived up to the terms of their contractual agreements with the government.

The RTC, although it was in a different business than HUD is today, was required to address the same issues of great demands upon a limited institutional capacity. One significant lesson from that experience is that sound program design can greatly reduce the demands for supervisory resources. Moreover, the evolution of the RTC approaches reveals a willingness to explore alternatives and learn lessons from each transaction.

For HUD, such experimentation can help to devise the partnership arrangements that can best serve the department's need for enhanced institutional capacity to manage its multifamily portfolio. Sound design also will serve the interests of the many communities that will need to cope with the impact of impending reductions in federal rental assistance levels for hundreds of thousands of people and thousands of assisted properties across the country.