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New England Office of District Inspector General for Audit, 1AGA
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Room 370
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Audit Memorandum
No: 00-BO-111-0802

September 29, 2000

MEMORANDUM FOR: William C. Apgar, Assistant Secretary for Housing, H

FROM: Stephen D. King, Acting District Inspector General, Office of Audit, 1AGA

SUBJECT: Section 8 Contract Renewal Process

Introduction

The purpose of our review was to assess the appropriateness, economy and efficiency of Section 8 contract renewals and Departmental efforts to encourage owners not to opt out of affordable housing programs. To offer owners an alternative to opting out of their Section 8 contracts, HUD announced a plan to Mark Up to Market (MUTM) on April 30, 1999. Congress later codified the Emergency Initiative (as the Mark-Up-to-Market Option) in the *Preserving Affordable Housing for Senior Citizens and Families into the 21st Century Act of 1999* on October 20, 1999.

MUTM has reduced opt outs, however, opt outs continue as owners of 2,404 units opted out after HUD published Notice H99-15 *Emergency Initiative to Preserve Below-Market Project-Based Section 8 Multifamily Housing Stock* on June 16, 1999.

MUTM retains affordable housing at an increased cost. In our sample, the average increase was $133 per unit per month. MUTM properties are not being renewed on a timely basis. Owners are continuing to opt out, despite MUTM, because they find the conventional market offers: 1) increased financial rewards with less restrictions and 2) fewer frustrations with the regulations, the changes to the Section 8 Program, and the uncertainty of Congressional appropriations. When the owner opts out, HUD provides vouchers to the tenants. For our sample, 66 percent of the tenants who received vouchers are still in their original apartment buildings.

We have made three (3) recommendations to strengthen HUD's controls and streamline processing under MUTM. Streamlining the MUTM process could result in fewer Section 8 opt outs. The recommendations will be controlled in the Departmental Automated Audits Management System. For each recommendation, please advise us within 30 days of: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why the action is not considered necessary. Also please furnish us with copies of any correspondence or directives issued.

If you or your staff have any questions, please contact Walter Hammer, Assistant District Inspector General for Audit at 617-565-5259.

Summary

The purpose of our review was to evaluate the appropriateness, economy and efficiency of Section 8 contract renewals and Departmental efforts to encourage owners not to opt out of affordable housing programs. The United States is experiencing a very strong economy. In 1999, rents rose faster than inflation for the third consecutive year. Under this strong economy, many owners of HUD-subsidized properties are finding it more attractive to opt out of their Section 8 contracts. HUD needed to take steps to reduce the number of opt outs within the Section 8 Program. In Spring 1999, HUD created Mark Up to Market (MUTM) to offer owners a financial alternative to opting out of their Section 8 contracts.

We found that MUTM retains affordable housing at an increased cost; however, MUTM properties not being renewed on a timely basis. Owners are continuing to opt out despite MUTM because they find:

1) Increased financial rewards in the conventional market with less restrictions and

2) Fewer frustrations with the regulations, the changes to the Section 8 Program and the uncertainty of Congressional appropriations.

In our discussions with owners of 68 properties in 14 states who elected the MUTM option, we learned that owners of 61 percent of the properties would have opted out if MUTM had not been available. MUTM helped HUD to retain 4,164 units of project-based affordable housing at these properties. Only 48 of the 68 properties had completed processing and executed contracts at the new, higher rents. For these 48 properties HUD could invest up to an additional $7.5 million per year.

Additionally, MUTM properties are not being renewed on a timely basis—on average 180 days after the prior Section 8 Contract expires. Under ideal circumstances, the owners submit their requests to participate in MUTM and their Rent Comparability Studies 120 days in advance of the expiration date of their contract. HUD then utilizes the 120 days to:

1. Determine if the property is eligible for MUTM,
2. Have a contractor conduct a second Rent Comparability Study to determine market rents for HUD,
3. Compare its study to the owners' study,
4. Calculate the new rental level,
5. Calculate the anticipated monetary need of the contract and obligate funds for the contract, and
6. Execute the contract for one year with four (4) one-year renewals.

For the contracts in the 14 states we examined:

- Owners submitted documentation ten days, on average, after the Section 8 contract expired (or 130 days late).

- HUD's determination of the property's eligibility is delayed due to the owners changing their minds about the type of renewal being requested and the need to evaluate owners' waiver requests.

- HUD's Rent Comparability Studies are obtained and returned 116 days, on average, after the previous Section 8 Contract(s) expire.

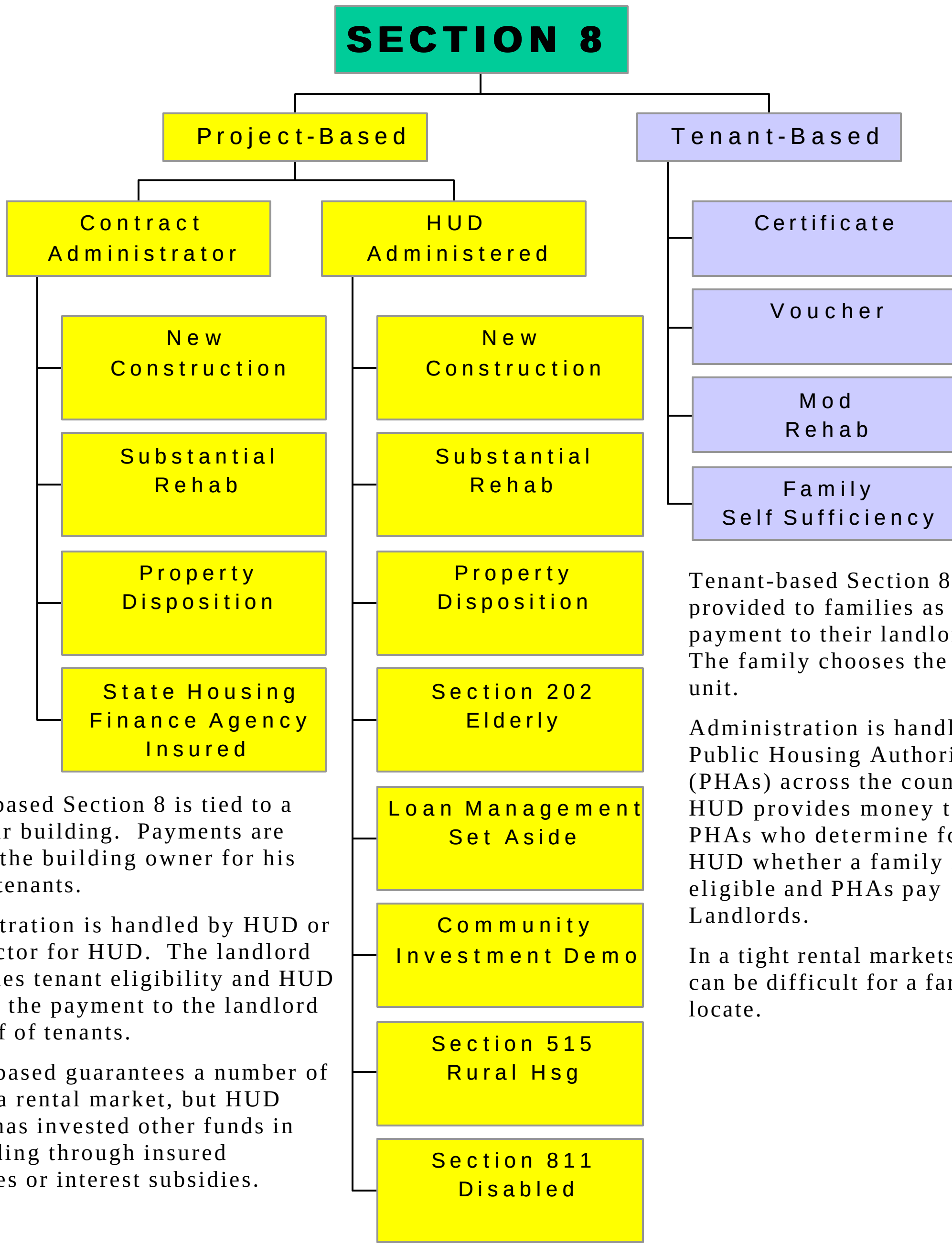
- Funding for the MUTM Section 8 contract(s) is being completed 159 days, on average, after the previous Section 8 contract(s) expire.

Owners are continuing to opt out because they find opting out more attractive than continuing in the Section 8 Program. Streamlining the MUTM process could result in fewer opt outs.

We met with HUD staff to discuss our issues during the course of our audit. On August 25, 2000, we provided a copy of our draft report to the Office of Housing. We received their comments on September 29, 2000 and have included pertinent comments in our report. The Office of Housing's response is included in its entirety in Appendix B.

Background

Over twenty-five years ago, the Federal Government created the Section 8 Housing Assistance Payments Program. The Section 8 Housing Assistance Payments Program is a rental subsidy program that assists eligible low-income families to obtain decent, safe, and sanitary housing. It consists of various subprograms, designed to reflect the different types of housing and delivery mechanisms available. HUD is assisting more than 3 million families under the Section 8 Program.



Project-based Section 8 is tied to a particular building. Payments are made to the building owner for his eligible tenants.

Administration is handled by HUD or a contractor for HUD. The landlord determines tenant eligibility and HUD provides the payment to the landlord on behalf of tenants.

Project-based guarantees a number of units in a rental market, but HUD usually has invested other funds in the building through insured mortgages or interest subsidies.

Tenant-based Section 8 is provided to families as a payment to their landlord. The family chooses the rental unit.

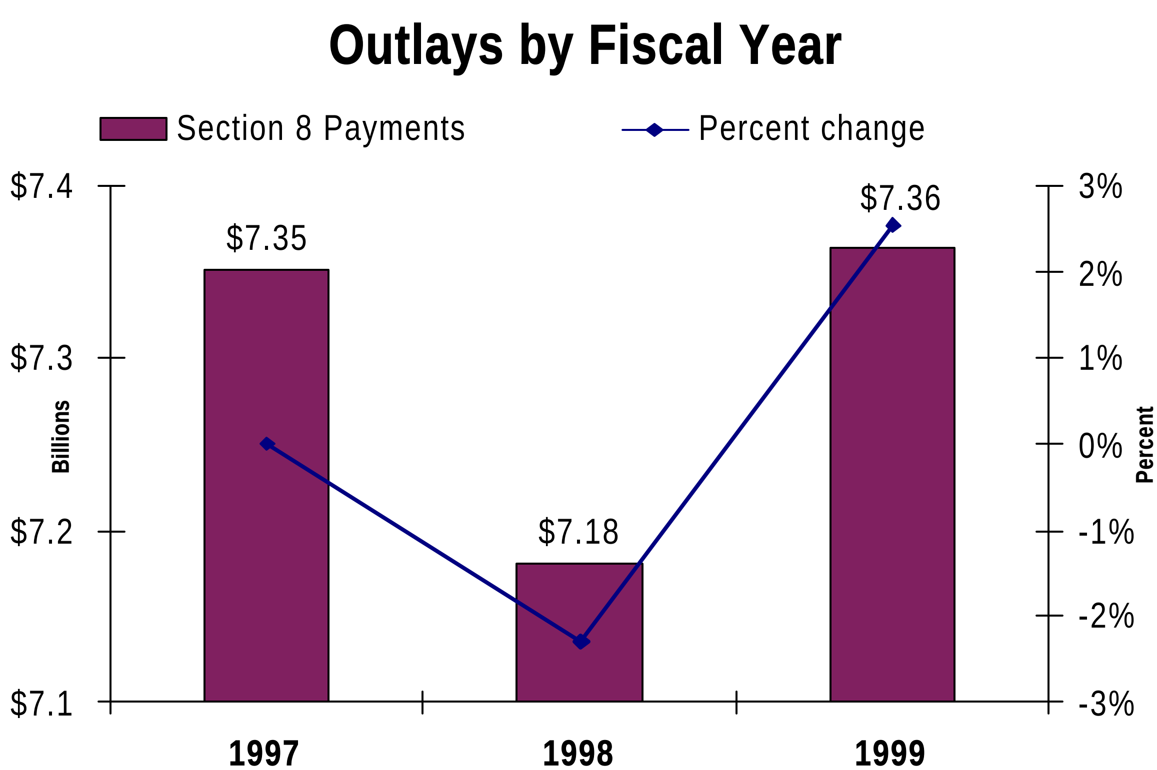
Administration is handled by Public Housing Authorities (PHAs) across the country. HUD provides money to PHAs who determine for HUD whether a family is eligible and PHAs pay Landlords.

In a tight rental markets, units can be difficult for a family to locate.

HUD's Office of Housing is responsible for renewing the majority of the project-based Section 8 Housing Assistance Payment contracts with property owners. HUD's Office of Public Housing oversees the Public Housing Authorities administering the vouchers under the tenant-based Section 8 contracts.

Beginning in 1995, budget constraints limited Section 8 contract renewals to a one-year period. Prior Section 8 contracts had been in force for five-year to forty-year periods. Because of this change, an increasing number of contracts had to be renewed and re-renewed each year. In Fiscal Year 1997, contracts for almost 800,000 units came up for renewal while contracts for over 1 million units will come up for renewal by the end of fiscal year 2000. Also, in June 1997, HUD began implementation of its HUD 2020 Management Reform Plan. HUD's Headquarters and Field organizational framework underwent dramatic changes while reducing staff by 25 percent. Many functions previously performed in the Field Office offices were centralized into new centers including the Real Estate Assessment Center, the Enforcement Center and the Office of Multifamily Housing Assistance Restructuring.

At June 30, 2000, there were 23,267 properties with 26,989 Section 8 contracts. A property can have more than one Section 8 contract. Actual outlays for these contracts for Fiscal Years 1997 through 1999 were:



A list of outlays by State and Trust Territory is presented in Appendix A.

Over 7,500 Housing Assistance Payment contracts came up for renewal between October 1, 1998 and June 30, 2000. At least 120 days in advance of their Section 8 contract's expiration date, property owners are required to notify HUD whether the owner wishes to renew the contract. Depending on the individual projects' type and prior participation in other HUD programs, owners may need to also submit a Rent Comparability Study to HUD. At the expiration of the current Section 8 contract, the owners' options are:

1) Renew at current rents if the Rent Comparability Study shows that market rents are equal to or higher than the expiring contract rents,

2) Renew with a rent increase under the Mark Up to Market (MUTM) program if the Rent Comparability Study indicates that market rents exceed both the current contract rents and 110 percent of Fair Market Rents in the local area (If market rents exceed the expiring contract rents but are less than 110 percent of aggregate Fair Market Rents, the owner can request a waiver from HUD in order to participate in the MUTM program),

3) Renew at rents lower than the expiring contract rents where the Rent Comparability Study indicates market rents are below the expiring contract rents,

4) Request a restructure of their insured mortgage when the Rent Comparability Study indicates market rents are so far below the expiring contract rents that the owner believes they cannot operate and maintain the property,

5) Renew under a previously approved plan for properties that have completed Portfolio Re-engineering or Preservation,

6) Opt out of the Section 8 contract where HUD no longer pays the owner Housing Assistance Payments to subsidize rents for low income families.

Renewals where the property owners' comparability study shows that market rents are lower than contract rents are referred to HUD's Office of Multifamily Housing Assistance Restructuring (OMHAR). OMHAR conducts an analysis of the effect that a rent reduction will have on the ability of the owner to maintain the property and service the debt. Based on its analysis, OMHAR either renews the contract at the lower market rate or restructures the mortgage to reduce the debt burden on the property to ensure financial stability. As OMHAR is a separate entity outside the Office of Housing, we did not evaluate properties submitted to OMHAR.

The remaining options are processed by HUD's Office of Housing. If the owner requests to participate in the MUTM program, the Office of Housing obtains its own Rent Comparability Study and compares it to the owner's Rent Comparability Study. If the difference between the Rent Comparability Studies is less than 5 percent, then the contract is renewed at rents from the owner's Rent Comparability Study. If the difference is greater than 5 percent, then HUD sets the final rents at 105 percent of HUD's Rent Comparability Study. There is no negotiation with the owner nor is there any appeal process. In cases where market rents are determined to exceed 150 percent of Fair Market Rents, the field offices must refer the renewal to Headquarters for review and approval.

Owners that elect not to renew their Section 8 contracts must meet certain legal requirements regarding any existing Use Restrictions. Owners also must notify both HUD and the tenants of the property notice of their intention to opt out one year in advance of their contracts' expiration dates. When the owners opt out, HUD provides Section 8 vouchers to eligible tenants to prevent rent increases to such tenants.

With the strong economy driving rents, many owners of HUD-subsidized properties were choosing to opt out of their Section 8 contracts to increase their rental income. In his remarks to the U. S. Conference of Mayors - Annual Meeting, New Orleans on June 12, 1999, the Secretary said:

> *Cruel irony: the strongest economy in history has also created the highest need for affordable housing in history. Why? Because the economy is so strong, it's driving up rents so fast, that those people on the bottom, or on fixed incomes, can't reach the rents. So we have 5.3 million American families, the highest number in history who need affordable housing, but people don't know it.*

HUD needed to take steps to reduce the number of opt outs within the Section 8 Program.

Mark Up to Market

In 1999, HUD developed an Emergency Initiative called Mark Up to Market to increase the Section 8 rents of certain properties up to market in order to preserve vital affordable housing stock. Many of the provisions of this Emergency Initiative were built into the FY 2000 Appropriations Act that continued and expanded the MUTM program with some changes.

Owners of expiring Section 8 contracts need to hire an independent appraiser to identify the aggregate market rent potential of their property. Owners need to compare the market rent potential to the aggregate Section 8 Contract rent potential. If the market rent potential exceeds the expiring Section 8 Contract rent potential, then the owner could request that HUD renew their Section 8 contracts at market rent. To participate in MUTM, an owner must have:

1. A Real Estate Assessment Center physical inspection score of 60 or above with no uncorrected Exigent Health and Safety violations,

2. For-profit or limited-distribution ownership,

3. Comparable market rents at or above 110 percent of the Fair Market Rent potential, and

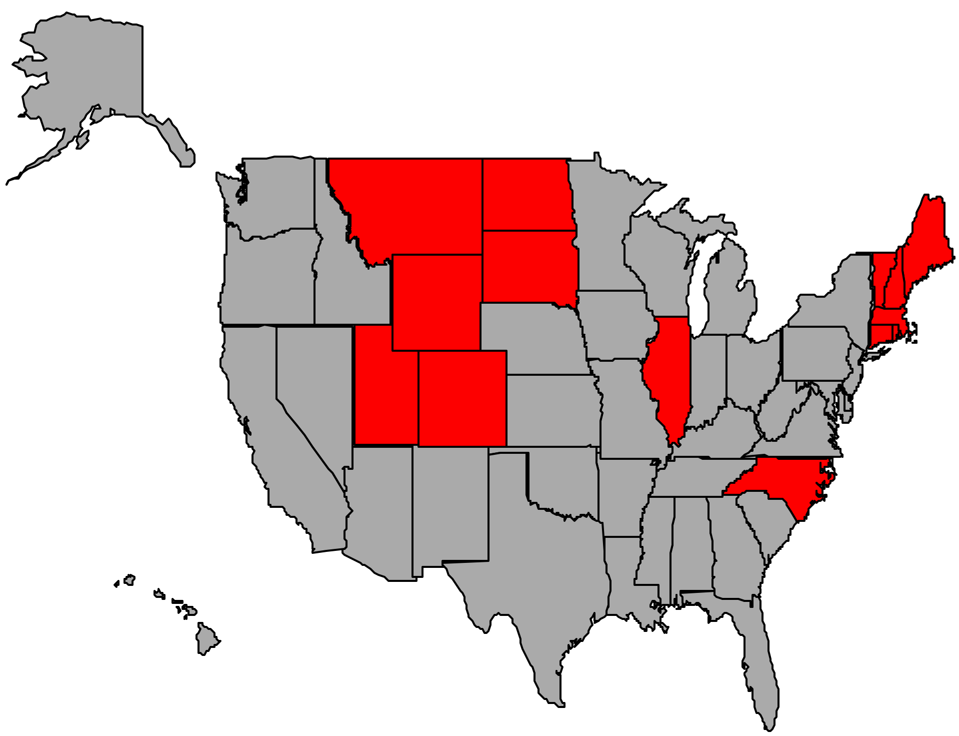
4. No low- and moderate-income Use Restriction on the property that cannot be eliminated by unilateral action by the Owner.

Objectives And Scope

The objectives of our review were to evaluate the appropriateness, economy and efficiency of Section 8 contract renewals and Departmental efforts to encourage owners not to opt out of affordable housing programs. We conducted our review from September 1999 to July 2000.

To evaluate the appropriateness, we examined contracts, inspections, rent comparability studies, and correspondence. Our evaluation of economy and efficiency led us to prepare timelines showing the progress of renewals. We held discussions with Hub Directors and Directors of Project Management and their staffs at six offices as well as various officials in the Headquarters Office of Housing and Office of Budget. We downloaded and correlated statistics on almost 27,000 contracts from the Office of Housing's Real Estate Management System. We contacted 60 PHAs to determine the residency status of tenants when property owners chose to opt out of their Section 8 contracts. We interviewed over 100 owners regarding their decisions to opt out or renew their Section 8 contract(s) under MUTM.

We examined the processing of Section 8 Contract Renewals for properties whose owners had elected to participate in MUTM. Property owners for approximately 4.7 percent of the 7,503 contracts that came up for at least one renewal between October 1, 1998 and June 30, 2000 elected to renew under MUTM. We examined operations at HUD offices administering properties in 14 states.



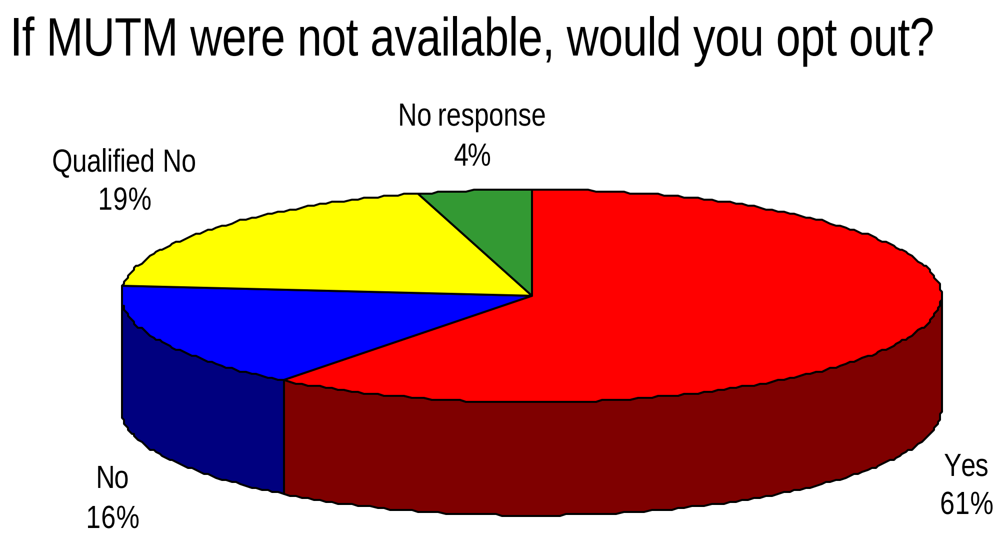
In these 14 states, owners with 72 contracts comprising 6,991 units have requested to participate in MUTM. Of these contracts, 50 have completed the MUTM process as of July 14, 2000.

Finding: Streamlining the MUTM Process Could Result in Fewer Section 8 Opt Outs

Mark Up to Market (MUTM) was created so that HUD could offer owners an alternative to opting out of their Section 8 contracts. MUTM retains affordable housing at an increased cost; however MUTM properties are not being renewed on a timely basis. New Section 8 contracts for MUTM properties are executed 180 days, on average, after the expiration of the prior Section 8 contract. There are several reasons why the process is taking this long. Some reasons are related to the owners' actions or inactions. Other reasons stem from circumstances within HUD. Owners are continuing to opt out because they find opting out more attractive than continuing in the Section 8 Program.

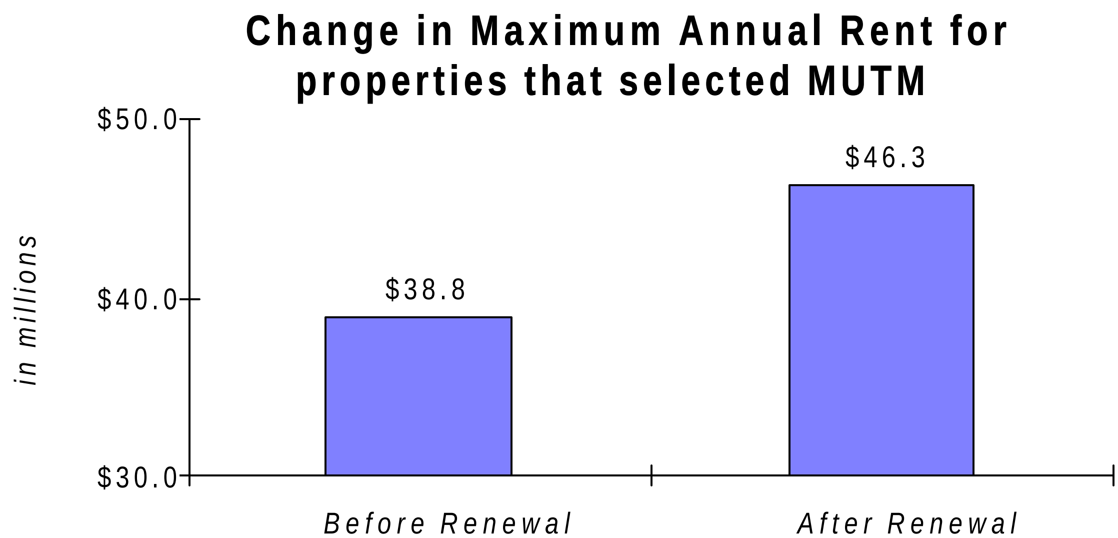
MUTM retains Project-based Affordable Housing

As of June 30, 2000, HUD records indicate that, nationally, owners of 296 contracts with 23,193 assisted units have elected to participate in MUTM. Owners of 61 percent of the 68 properties in our 14 sample states advised that they would have opted out if MUTM had not been available. As a result of MUTM, HUD retained 4,164 units of project-based affordable housing in these 14 states. While owners of 35 percent of the properties advised they would not have opted out, 19 percent limited their answer by stating they would not opt out this year, but would likely opt out in the future.



Maximum Annual Rent increased under MUTM

For the 50 contracts in our sample that completed MUTM, HUD could invest an additional $7.5 million per year.

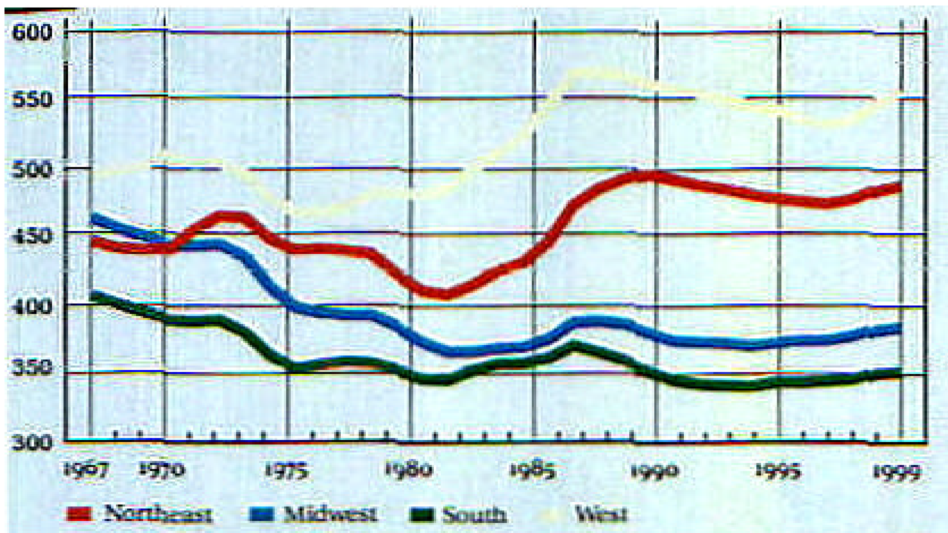


Increases due to MUTM vary by state with the largest increases in the New England states. For the 50 completed contracts, the average increase per unit per month was $133.

State*	Contracts	Assisted Units	Monthly Rent Before Renewal	Monthly Rent After Renewal	Increase per unit
Colorado	1	118	$294	$ 415	$121
Illinois	8	739	$590	$ 648	$ 58
Massachusetts	8	1,665	$905	$1,175	$270
Montana	1	60	$304	$ 377	$ 73
North Carolina	25	1,699	$493	$ 527	$ 34
New Hampshire	6	326	$581	$ 722	$141
Rhode Island	1	100	$518	$ 623	$105
Sum/Average	**50**	**4,707**	**$653**	**$ 786**	**$133**

**The states of Connecticut, North Dakota, South Dakota, Utah, Vermont, and Wyoming were included in our sample however there were no MUTM properties in these states at June 30, 2000. The MUTM properties in the state of Maine had not completed MUTM processing by July 14, 2000.*

In its report *Out of Reach*, dated September 1999, the National Low Income Housing Coalition identified five of the six New England states (excluding Maine) as some of the least affordable in the nation. They advised that 45 percent to 51 percent of renters in these states would be unable to afford a two-bedroom apartment at Fair Market Rents. While the other states in our sample are not as expensive as New England, their need for affordable housing is no less. The Joint Center for Housing Studies of Harvard University included the following chart showing the trends in rents geographically over time in its *State of the Nation's Housing 2000* report:



It also reported that rental markets strengthened in 1999 as rents rose faster than inflation for the third consecutive year.

MUTM processing is not timely

For the 50 contracts that completed MUTM processing, a new Section 8 contract was executed 180 days on average, after the prior contract had expired. While the average was 180 days, time ranged from 1 day to 547 days. For many properties, HUD and the owner executed short term renewals at current rents to provide operating funds to the properties while MUTM was in process.

Under MUTM, the property owner submits a request to MUTM along with a Rent Comparability Study showing that market rent potential of the property. HUD staff determine if the property is eligible for MUTM. For eligible properties, HUD has a contractor conduct a second Rent Comparability Study to determine the market rents. HUD compares its study to the owners' study. If the owners' study is within 105 percent of the HUD study, rents are set at the level determined by the owners' study otherwise HUD offers a contract with rents set at 105 percent of the HUD study. Using these rent levels, HUD calculates the anticipated monetary need of the contract and obligates funds. After funds are obligated, HUD sends a contract to the owner for signature. After receiving the owners' signed contract, HUD executes the Section 8 contract for one year with four (4) one-year renewals subject to annual appropriations.

On average, it took 277 days to turnaround the Section 8 contract from the date that the election was required to the date that the new contract was executed. There are many reasons why the turnaround on the Section 8 contracts took this length of time:

- owners did not submit their requests on time
- owners changed their mind on the type of renewal they wanted
- delays due to HUD's decision regarding waiving a condition required for MUTM
- delays due to obtaining HUD's Rent Comparability Study
- delays due to HUD's funding properties

Owners' Submissions are Late

According to HUD Notice H99-36 *Project-based Section 8 Contracts Expiring in Fiscal Year 2000* dated December 27, 1999, owners are required to submit their decision regarding the type of renewal with their Rent Comparability Study to HUD at least 120 days prior to the expiration of their contract. On average, owners were submitting these document ten days after the contract expired. This delay is one of several factors contributing to the fact that HUD is not renewing Section 8 MUTM contracts on a timely basis.

Owners are Changing their Minds

For 8 percent of the contracts that we reviewed, the owners changed their mind about the type of renewal. Owners changing their mind about the type of renewal lengthens the time to process the renewal. Depending upon their properties' situation, owners can choose to:

- Renew their Section 8 contract at current rents
- Renew at market rents when the Rent Comparability Study indicates market rents are less than the expiring Section 8 contract rents.
- Request a restructure of their underlying debt
- Renew under an approved plan for portfolio re-engineering or preservation
- Request Renewal under MUTM
- Opt out

Owners would initially select to renew at current rents, then examine their Rent Comparability Studies and determine that market rents were higher than their current rents, and then, change their selection to participate in MUTM. Timing was also a factor in the cases where owners changed their minds. Many of the owners who changed their minds were making their decisions in the spring and summer of 1999 when MUTM was a new program. MUTM was announced by HUD in April 1999; however, HUD did not publish Notice H99-15 *Emergency Initiative to Preserve Below-Market Project-Based Section 8 Multifamily Housing Stock* until June 16, 1999. Notice H99-15 advised owners of the benefits and requirements of the MUTM program.

Waivers

For properties that do not meet the initial eligibility criteria, property owners can request that HUD waive the initial eligibility criteria to allow the property to participate. In FY 2000, Congress provided $100 million for marking rents up to market. In order to ensure that HUD had adequate funds for the properties, waivers were submitted to Headquarters for approval. We examined MUTM processing at HUD offices with jurisdiction over 14 states. For these states, eighteen waivers have been requested as of July 14, 2000. The status of these waivers was:

- Eight properties with waivers granted have completed MUTM;
- Five properties with waivers granted were in the MUTM process;
- Waiver requests for three properties were being evaluated by HUD;
- Waiver requests for two properties were returned to the owners. The owners did not provide sufficient information to determine that the property meets the criteria required for a waiver.

Headquarters is not making decisions regarding waiver requests on a timely basis. For the thirteen waivers granted, HUD Headquarters took an average of 96 days to approve the waivers.

State	Contracts	Average Days
Colorado	1	15
Illinois	2	140
Massachusetts	6	108
New Hampshire	2	69
North Carolina	2	78
Sum/Average	**13**	**96**

Property owners requested that HUD either waive: (1) requirements that determine eligibility to participate in MUTM or (2) the 150 percent of Fair Market Rent cap on maximum rental increases. Seven of the thirteen approved waivers deal with the eligibility criteria that a property's market rent potential must be greater than 110 percent of the Fair Market Rents for that property. Four additional approved waivers permit the property to receive rents in excess of 150 percent of the Fair Market Rents. The other two approved waivers allowed properties with Use Restrictions to participate in MUTM. These two properties were permitted to mark up to the maximum rent level imposed by their Use Restrictions.

Eight of the thirteen properties with approved waivers have completed the renewal process. Approved waivers for five of these eight properties dealt with the eligibility criteria which required that a property's market rent potential be greater than 110 percent of the Fair Market Rents.

Property ID	State	Assisted Units	Rent potential at FMRs	Rent potential before Waiver	Pre waiver rents as a % of FMRs	Rent potential after Waiver	Post waiver rents as a % of FMRs
800008473	MA	160	$1,309,380	$846,948	65%	$1,255,860	96%
800013754	NH	63	$321,900	$337,680	105%	$362,772	113%
800013881	NH	50	$490,680	$305,520	62%	$460,440	94%
800012770	NC	40	$222,720	$230,880	104%	$230,880	104%
800013274	NC	28	$155,904	$149,184	96%	$150,192	96%
Sum/Percentage		**341**	**$2,500,584**	**$1,870,212**	**75%**	**$2,460,144**	**98%**

Owners of four of these five properties stated that they would have opted out if MUTM was not available. The owner of the fifth property would have considered opting out. Three of these five owners commented that the waivers took a long time to process.

If the market rent potential of these properties had exceeded 110 percent of the Fair Market Rents, these properties would not have needed a waiver. HUD has a vested interest in retaining affordable housing. Owners who have already opted out have advised that frustration with delays and paperwork were a large factor in their decision to opt out. Therefore; the MUTM eligibility requirement that market rents be 110 percent of the local Fair Market Rents should be evaluated.

Of the 18 waivers requested, four were from property owners requesting the 150 percent of Fair Market Rent cap on rental increases be waived. One of these requests has been approved while the other three are pending. Rents at the property with the approved waiver increased, $278 per unit per month (PUPM).

Property ID	Rent potential before Waiver	Rent potential after Waiver	Annual Difference	Assisted Units	Increase PUPM
800008659	$1,716,030	$2,143,200	$427,170	128	$278

For properties whose market rent potential exceeds 150 percent of the Fair Market Rents, property owners may request that HUD waive the cap if the property meets one of three criteria:

1. Has a high percentage of the units rented to elderly families, disabled families, or large families;

2. Is located in a low-vacancy area where family-based vouchers would be difficult to use and there is a lack of comparable rental housing; or

3. Is a high priority for the local community as demonstrated by a contribution of State or local funds to the property.

HUD has also received waiver requests from owners to permit properties with Use Restrictions to participate in MUTM. In its simplest form, a Use Restriction is an agreement between two entities to limit how a particular property can be utilized. Most Use Restrictions guarantee that a property remains affordable in exchange for a monetary incentive such as an interest reduction payment, a lower interest rate on a loan, additional funding under a Flexible Subsidy agreement, or lower property taxes. There are several kinds of Use Restrictions including prior or present Flexible Subsidy assistance, a Section 236 or Section 221(d)(3) BMIR mortgage with a prepayment restriction, a risk sharing mortgage with affordability restrictions, a preservation property with a recorded Use Agreement, properties financed with Low-Income Housing Tax Credits under Section 42 of the Internal Revenue Code, certain Section 515 loans, certain Section 202 properties, and tax agreements between property owners and the city where their property is located.

Delays due to Obtaining HUD's Rent Comparability Study and Funding

For each property requesting MUTM, HUD is determining rent levels at market. Prior to MUTM, Section 8 rents were based upon a contract level either: 1) set by a budget or 2) based upon last year's rent potential multiplied by an adjustment factor. Beginning in fiscal year 1999, HUD began setting Section 8 Contract rents for expiring contracts at the same level as the property owner could obtain in the unassisted market.

If the market rent potential in the owners' Rent Comparability Study is at or above 110 percent of the Fair Market Rents, HUD orders its own Rent Comparability Study from an independent appraiser. The processing time for the Rent Comparability Studies averaged 49 days. On average, Rent Comparability Studies were completed with a review by HUD 116 days after the Section 8 contract expired. Under the terms of their contracts, the contractors were given 30 days to complete the Rent Comparability Studies and return them to HUD.

Certain properties experienced much longer delays than others due to:

- The lack of assigned funding for HUD's Rent Comparability Study between October 1999 and December 1999 and/or

- The need to secure additional or new contractors because the need for appraisal services exceeded management's expectations

Depending on the Field Office, different methodologies were used to obtain an independent appraiser to perform HUD's Rent Comparability Studies. The source of funding to pay the contractor to perform the Rent Comparability Studies is the underlying appropriation for that property. Different types of properties are funded from different appropriations. One office set up multiple contracts with a not-to-exceed clause for appraisal services. Each contract was tied to a specific appropriation. The majority of the properties that needed the Rent Comparability Studies were properties that fell under one type of appropriation. HUD's contract to conduct Rent Comparability Studies for that type of appropriation ran out of funding; therefore HUD had to create a new contract. Delays in obtaining the Rent Comparability Studies occurred because of the need to create and fund a new appraisal contract for that type of property. Another office did not expect to need many Rent Comparability Studies, so they did not have a contract in place. Many Rent Comparability Studies were needed all at once, leading to delays in executing the MUTM contracts. On average, funding for 50 MUTM properties that completed processing occurred 159 days after expiration of the prior Section 8 contract with 42 days needed to fund the contract.

Retroactive Rent Increases

Certain owners refused the short-term renewals during MUTM processing. These owners received retroactive payments at the increased rental levels. In the intervening time frame, these owners either funded operations themselves or withdrew funds from the properties' reserve for replacements.

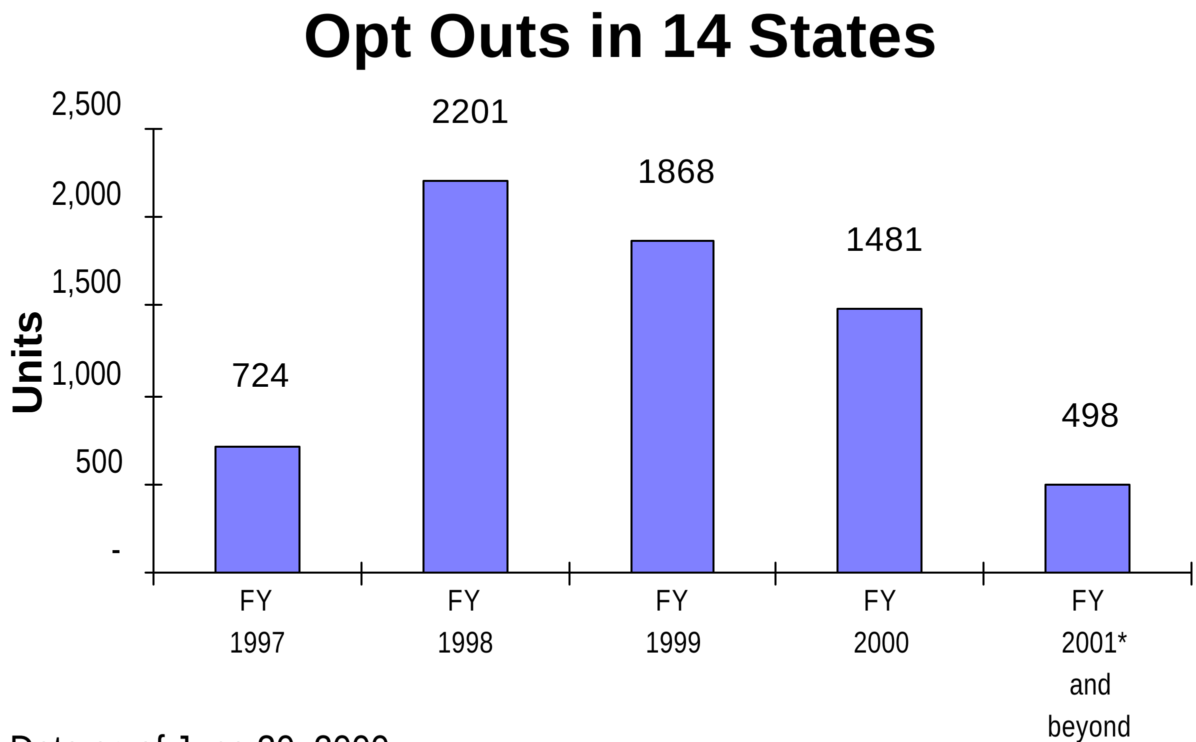
The request to participate in MUTM states:

> *If necessary to process this request, I agree to enter a three-month, short-term renewal at current rents.*

Staff believe that it is appropriate to make retroactive rent increases because, if processing were completed as planned, multiple short term renewals would not be needed. Since a large number of owners are not submitting the required documentation to begin processing in a timely fashion, this impedes HUD's ability to complete processing by the contract's expiration date. By making retroactive payments at the increased rental levels to owners who do not enact a short term renewal or owners who do not submit documentation 120 days in advance of their contracts' expiration, HUD is rewarding owners who are not complying with HUD's requirements.

Even with MUTM, Opt Outs continue

HUD developed MUTM to discourage owners from opting out of the Section 8 Program. MUTM came into existence in April 1999. While there has been a decrease in the number of units opting out in our sample states since MUTM was implemented, opt outs continue.



Data as of June 30, 2000

As of June 30, 2000, owners of 5,695 units have opted out in the 14 states we reviewed. Owners of another 1,234 units have notified HUD of their intent to opt out of the Section 8 Program by September 30, 2001. HUD advises that an owner's notification of his or her intent to opt out is not final as owners can and do change their minds up to the last minute. HUD also states that they are trying to convince owners to renew their contracts rather than opt out. There are significant variations from state to state.

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001+	Total
Colorado	495	786	191	309	124	1,905
Connecticut	38	22	16	173	0	249
Illinois	0	100	150	157	273	680
Maine	0	0	32	0	0	32
Massachusetts	117	212	850	311	0	1,490
Montana	0	196	55	123	60	434
New Hampshire	0	24	65	74	0	163
North Carolina	0	671	206	181	35	1,093
North Dakota	0	65	40	30	0	135
Rhode Island	0	0	0	10	0	10
South Dakota	0	43	70	28	0	141
Utah	74	82	57	28	6	247
Vermont	0	0	0	0	0	0
Wyoming	0	0	136	57	0	193
Total	724	2,201	1,868	1,481	498	6,772

Note: Data as of June 30, 2000. FY 2001+ includes units whose expiration date is beyond FY 2001. Some owners whose properties have multiple Section 8 contracts have notified HUD of their election to opt out of all contracts at these properties.

The preceding table shows the number of units whose owners elected to opt out. To understand the impact, correlate the units that opted out against the units coming up for renewal in FY 2000.

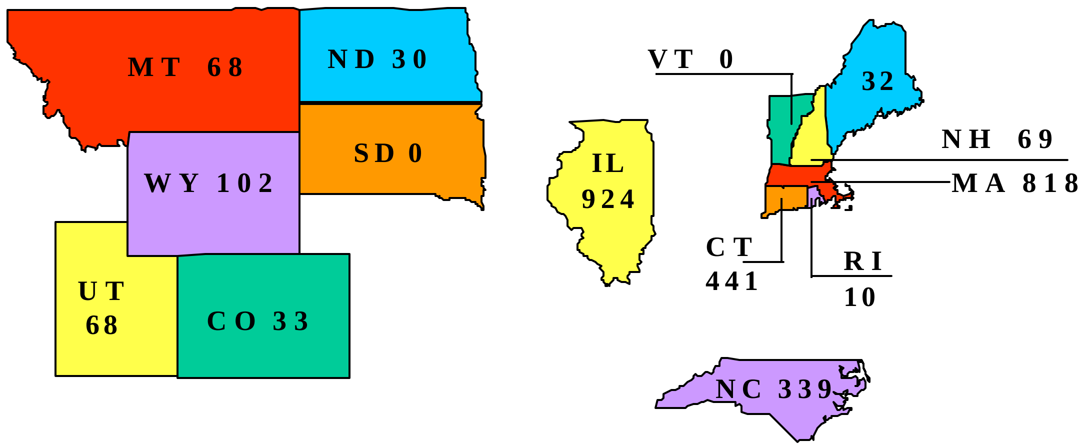
	Section 8 units that opted out	Section 8 units that came up for renewal	Percentage
Colorado	309	7,926	4%
Connecticut	173	5,473	3%
Illinois	157	24,612	1%
Maine	0	1,651	0%
Massachusetts	311	21,693	1%
Montana	123	3,171	4%
New Hampshire	74	1,932	4 %
North Carolina	181	9,873	2%
North Dakota	30	2,148	1%
Rhode Island	10	1,688	1%
South Dakota	28	2,836	1%
Utah	28	1,573	2%
Vermont	0	303	0%
Wyoming	57	1,058	5%
Site Totals	**1,481**	**85,937**	**2%**

By the close of FY 2000, HUD will lose 2 percent more of the affordable housing that could have been renewed. The need for affordable housing is increasing due to higher rents in the strong economy, but our stock of available privately-owned affordable housing is diminishing.

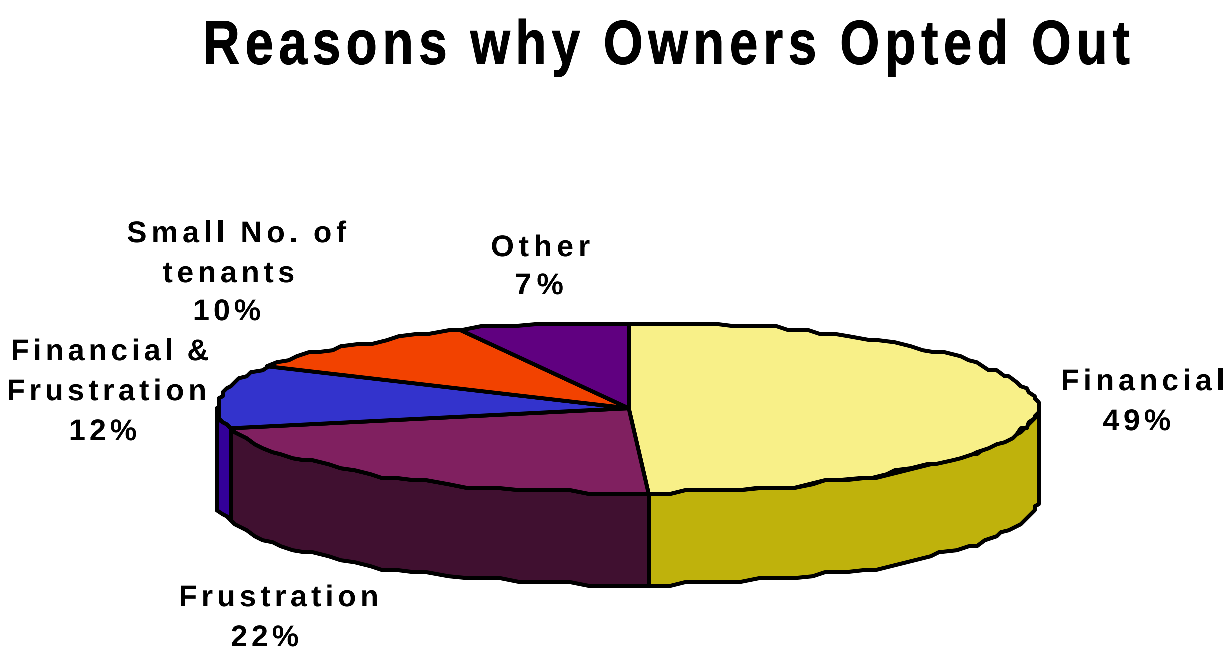
Many of these Section 8 contracts were coupled with FHA mortgages insured under Section 236 or Section 221(d)(3) of the National Housing Act. Under HUD's agreement with the owner, rents at these properties were capped. Because the rents were capped by this agreement, in many instances, the rents were lower than market. These units with capped rents provided an additional resource for affordable housing. If the owner opted out of his/her Section 8 contract and prepaid his insured mortgage, then additional units of affordable housing were lost.

Reasons why Owners are Opting Out

We interviewed owners who have decided to opt out on 2,934 Section 8 units located in these states:



Owners believed that opting out provided more opportunity for financial reward while eliminating the paperwork for re-certifying tenants. Many owners also were frustrated with changes to the program and the uncertainty of Congress appropriating sufficient funds on an annual basis to fund renewals.



Owners opted out of Section 8 contracts for 2,404 of 6,772 units after MUTM came into existence.

State	Section 8 units
Colorado	584
Connecticut	173
Illinois	484
Maine	32
Massachusetts	311
Montana	238
New Hampshire	74
North Carolina	226
North Dakota	54
Rhode Island	10
South Dakota	98
Utah	63
Vermont	0
Wyoming	57
Totals	**2,404**

These owners did not choose to participate in MUTM because: 1) the conventional market provides more opportunity with less restriction, 2) they were not eligible for MUTM, and 3) the percentage of Section 8 units to total units was too low to make recertification of tenants worth their effort. Under the project-based Section 8 Program, the property owner or their agent certifies the eligibility of each tenant upon whose behalf HUD pays subsidy. Under the tenant-based Section 8 Program also called vouchers, the PHA who administers the vouchers certifies the eligibility of each tenant upon whose behalf HUD pays subsidy

HUD provides Vouchers to Tenants when Owner Opts Out

When an owner decides to opt out, HUD provides vouchers to eligible tenants in residence at the time of opt out. These vouchers are administered by a public housing authority (PHA) who certified that each of the tenants who received a voucher was eligible for the voucher. We contacted PHAs to determine the housing situation of the tenants who resided at properties where the owner had opted out of the Section 8 contract. The PHAs were generally able to provide the disposition of tenants by property. Some properties had multiple project-based Section 8 contracts. The 6,772 units in our sample represent 133 properties. We examined the living situation of 4,654 tenants who reside at properties whose owners opted out of the Section 8 Program.

Upon review by the PHAs, 80 percent of the tenants living in these 4,654 units continued to receive subsidy. The remaining 20 percent is divided among tenants who did not qualify and units that were vacant at the time the PHA began administering the vouchers. The primary reason why a family would be denied is that the family's income was too high to qualify for Section 8 subsidy. Many families who were initially eligible for Section 8 became ineligible over time as that family's financial condition improved. Provided that the family remained a good tenant, they were welcome to continue to live at the property receiving project-based subsidy. A secondary reason why a family would be denied assistance is that they did not choose to recertify with the PHA. HUD regulations require that the family and the entity re-certifying the family (the PHA) go over the family's income, number of family members, and medical expenses to determine the amount of assistance that the family needs.

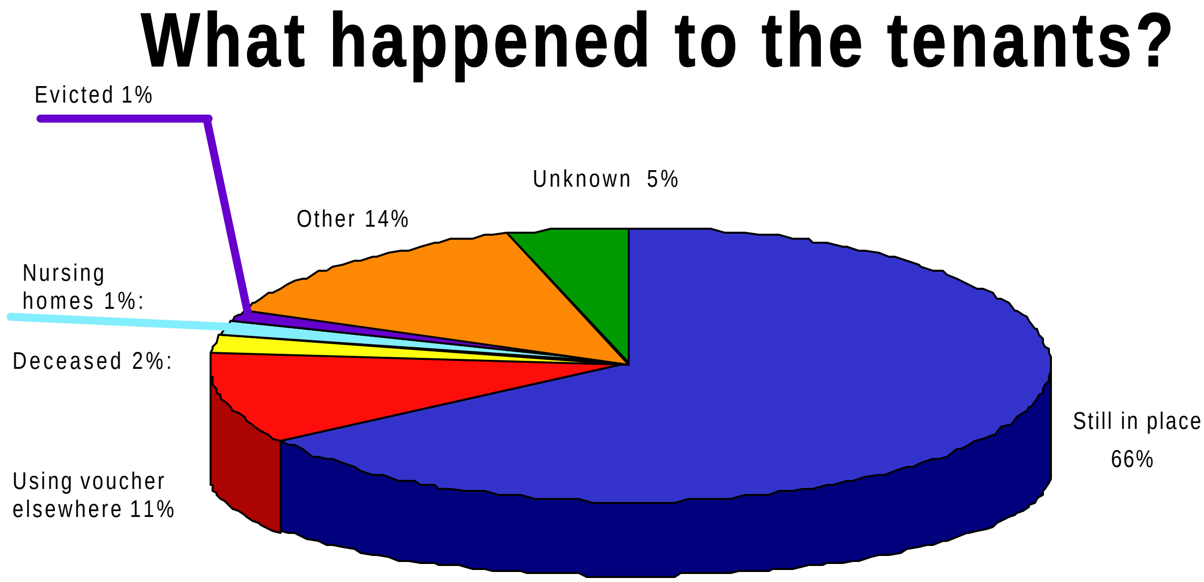
Many of the properties that opted out were insured with FHA mortgages under Section 236 or Section 221(d)(3) of the National Housing Act. Rents were capped at properties with these types of HUD-insured mortgages. As mentioned above, families whose financial condition improved, may no longer have qualified for Section 8 because they no longer needed assistance to pay the rents at the capped level. Because the market rent may be more than the capped rent, families living at a Section 236 or Section 221(d)(3) property, may become eligible for vouchers.

Tenants used Vouchers to Remain in Place

We obtained the disposition of tenant families for 83 properties. Upon recertification, vouchers were given to 80 percent of families reviewed. The PHAs who administer the vouchers for HUD attempted to recertify all tenants living at the property at the time of opt out.

What happened to Tenants when the Owners Opted Out of their Section 8 Contract?	
At time of opt out	
Families reviewed by the PHAs	4,654
Families that received vouchers:	3,699
Families that did not receive vouchers	955
As of July 1, 2000	
Families that received vouchers:	3,699
Tenants still at properties receiving vouchers:	2,430
Tenants with vouchers living elsewhere:	399
Tenants deceased:	77
Tenants in nursing homes:	58
Tenants evicted:	57
Tenants no longer covered by vouchers for other reasons:	506
Tenants no longer covered by vouchers for unknown reasons:	172

For families living in these units, 66 percent of the tenants who might have been displaced by opt outs remained at the same address. Another 11 percent of tenants continued to receive housing subsidy at another location.



Conversion to Tenant-Based Subsidy

When an owner opts out of a Section 8 contract and HUD provides vouchers to the tenants, the units are converted from project-based subsidy to tenant-based subsidy. Project-based subsidy maintains a number of units in a fixed location while tenant-based subsidy permits the families to select the housing of their choice. In tight rental markets, their choices are constrained because there is very little housing available.

Auditee Comments

The Office of Housing provided comments on September 29, 2000. They commented on the factual information included in our report. Housing also provided comments on each of the recommendations and intends to address some of the recommendations through its issuance of a Section 8 User Guide.

OIG Evaluation of Auditee Comments

Based upon Housing's response, appropriate revisions were made to the finding and recommendations.

Recommendations:

We recommend that your office:

1A. Analyze the Section 8 renewal process to develop the means to complete MUTM processing before the expiration of the Section 8 Contract.

1B. Complete the development and issuance of the Section 8 User Guide to: 1) provide details and instructions as to what is needed to expeditiously process waiver requests, and 2) authorize Field Offices to deny retroactive contract increases in contract rents to owners who fail to submit appropriate renewal data in a timely manner and who refuse to enter into short-term contract renewals.

1C. Ensure that the Section 8 User Guide is implemented.

Section 8 Housing Assistance Payments by Fiscal Year by State or Territory

State or Territory	FY 1997	FY 1998	FY 1999*
Alabama	$76,630,586	$76,270,692	$76,744,694
Alaska	10,157,745	9,623,288	8,944,362
Arizona	46,378,165	44,647,823	43,379,720
Arkansas	45,230,944	44,025,347	45,001,024
California	654,813,890	624,343,577	611,126,285
Colorado	84,495,992	81,044,237	81,612,769
Connecticut	160,399,679	158,060,435	168,561,101
Delaware	29,719,944	29,482,659	36,462,717
District of Columbia	87,003,604	83,211,060	87,370,807
Florida	222,658,633	220,456,106	219,335,499
Georgia	134,716,433	133,521,575	134,548,289
Guam	340,784	272,316	220,426
Hawaii	24,416,171	24,115,641	24,874,971
Idaho	22,502,798	21,523,463	21,304,869
Illinois	464,290,082	460,544,841	504,519,271
Indiana	137,259,730	136,941,914	136,749,639
Iowa	51,653,823	50,722,246	50,028,366
Kansas	45,280,665	44,486,873	44,462,236
Kentucky	106,677,966	105,214,196	118,374,283
Louisiana	87,619,640	85,893,545	85,239,772
Maine	60,098,954	59,258,685	62,506,768
Maryland	170,970,940	171,601,175	173,447,461
Massachusetts	412,635,509	412,894,116	426,269,836
Michigan	291,790,907	269,795,552	276,830,663
Minnesota	141,941,996	134,659,337	135,775,515
Mississippi	79,238,998	76,792,884	77,833,540
Missouri	119,427,849	116,624,281	115,277,388
Montana	19,093,066	18,377,859	16,826,906
Nebraska	25,016,419	24,373,550	23,797,213
Nevada	21,110,327	20,928,522	21,147,233
New Hampshire	39,273,985	39,129,798	39,954,543
New Jersey	368,062,123	354,764,191	378,496,072
New Mexico	22,923,176	22,310,686	22,431,058
New York	852,449,461	843,927,376	864,758,385
North Carolina	117,831,897	115,642,422	114,347,408
North Dakota	15,540,144	13,934,875	13,718,766
Ohio	379,424,889	371,727,756	383,704,808
Oklahoma	53,029,885	52,857,034	52,745,584
Oregon	54,224,546	51,397,782	52,935,775

Section 8 Housing Assistance Payments by Fiscal Year by State or Territory

State or Territory	FY 1997	FY 1998	FY 1999*
Pennsylvania	386,569,450	374,559,591	393,108,921
Puerto Rico	115,424,626	112,149,146	113,159,643
Rhode Island	109,652,437	111,194,281	115,884,978
Saipan	1,350,841	1,651,073	1,139,508
South Carolina	87,798,607	86,072,579	85,427,763
South Dakota	24,508,082	22,998,614	24,562,252
Tennessee	129,507,600	128,521,189	128,400,333
Texas	257,448,089	253,517,650	249,451,439
Utah	19,381,105	18,635,348	18,863,124
Vermont	23,968,629	23,542,727	23,854,155
Virgin Islands	7,755,816	8,113,971	7,985,165
Virginia	169,813,281	162,683,591	173,998,016
Washington	77,431,236	72,292,287	70,312,557
West Virginia	57,594,689	56,958,366	58,581,274
Wisconsin	134,862,466	132,112,661	136,471,164
Wyoming	11,101,216	10,775,699	10,374,871
Totals	**$7,350,500,515**	**$7,181,178,488**	**$7,363,241,185**

*****_For fiscal year 1999, the Office of the Inspector General was unable to perform sufficient procedures to render an opinion on HUD's financial statements, therefore we are using unaudited figures for 1999._

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

SEP 28 2000

MEMORANDUM FOR: Stephen D. King, Acting District Inspector General, Office of Audit, 1AGA

Reba G. Cook for

FROM: Shaun Donovan, Deputy Assistant Secretary for Multifamily Housing Programs, HT

SUBJECT: Section 8 Contract Renewal Process

This memorandum responds to the subject draft audit report dated August 2000. We have provided comment by finding and ask for your consideration of this response prior to issuance of the final audit report. In our review of the report, we came across several areas that we found to be technically incorrect and, as a result, we are providing you with references to those areas along with our recommendations for revisions.

Comments:

Memorandum, page one, Introduction, paragraph one, states, "Congress enacted an Emergency Initiative, also called Mark Up To Market (MUTM) in April 1999." It was HUD that enacted the Emergency Initiative in April 1999. Congress codified the Emergency Initiative (as the Mark-Up-to-Market Option) in the Preserving Affordable Housing For Senior Citizens And Families Into The 21st Century Act of 1999 (FY 2000 HUD Appropriations Act) on October 20, 1999.

Page 4, Background, flowchart, narrative, last paragraph, lower left column, states, "Project-based guarantees a number of units in a rental market, but is usually more expensive because HUD usually has invested other funds in the building through insured mortgages or interest subsidies." This is not an accurate statement and we recommend its removal. There are a large number of insured and non-insured that do not meet this description. This is an extremely inaccurate generalization of the Section 8 project-based program.

Page 6, paragraph one, states "If the owner wishes to renew, the owner is required to obtain and submit a Rent Comparability Study to HUD and to select an option for renewal. The options are:" Page 6 goes on to describe the six options available to owners. Our concerns with this paragraph are two-fold. First, the paragraph implies that all contracts coming up for renewal must conduct a rent comparability study and submit it to HUD; this is not the case. Owners of exception projects (Option 4), Owners of Preservation and Demonstration projects (Option 5) and Owners electing to opt-out (Option 6) are not required to submit rent comparability studies. Our second concern is the manner in which the options are explained. We do not believe that the language used in this section of the report accurately reflects the options available to owners. The options are:

1. Option One: Mark-Up-To-Market
   Owners may renew rents up to market if they meet program requirements
   (RCS Required)

2. Renew at rents for projects with rents at or below market
   General renewal for most contracts that are at or below market
   (RCS required)

3. Referral to OMHAR
   Projects referred for debt restructure or rent reduction to market
   (RCS required)

4. Exception Projects
   Initial renewal is at lesser of OCAF or Budget-based adjusted
   current rent
   (No RCS required)

5. Preservation/Demonstration Projects
   Renew according to Plan of Action
   (No RCS required)

6. Opt Outs
   (No RCS required)

Page 6, last paragraph, next to last sentence, states, "If the difference is greater than 5% then HUD negotiates with the owner to finalize the rents." When the difference between the two studies is greater than or equal to 105% of the HUD Comparable Rent Potential, the final Comparable Market Rents will be 105% of the HUD Comparable Market Rents. When the HUD Comparable Gross Rent Potential is above the Owner Comparable Gross Rent Potential, the Final Comparable Market Rents will be the Owner Comparable Market Rents. There are no negotiations with the owner nor is there any appeal process.

Page 7, Mark Up To Market section, the discussion of the Emergency Initiative implemented by HUD and the Mark-Up-To-Market statute authorized by Congress, should include a discussion of the 110% of fair market rent eligibility requirement. There are many owners who, absent a waiver of the 110% FMR requirement, opt-out of the project-based program because enhanced vouchers only became available beginning with passage of the FY 2000 HUD Appropriations Act on October 20, 1999. Previously, tenants living in a Section 8 assisted unit where the owner opted out received a standard voucher.

An enhanced voucher is defined as tenant-based housing assistance used to assist eligible families affected by certain types of housing conversion actions. Unlike a regular voucher, the subsidy may be "enhanced" to cover the difference between the normally applicable payment standard and the gross rent for families (assuming the PHA determines the rent is reasonable). Enhanced vouchers also have a special minimum rent requirement. These special features only apply if family the remains at the property in question.

All waiver discussions should be in one location, either here or on page 13; we prefer it be here.

Page 9, First paragraph, second sentence, states, "MUTM retains affordable housing at an increased cost; however MUTM projects are taking a long time to complete the renewal process." This statement is not accurate and should be removed from the report. The cost of issuing an enhanced voucher to an owner who elects to opt out of his/her Section 8 project-based section 8 contract costs at least as much as marking up a project-based contract. The last sentence in the paragraph states, "Streamlining the MUTM process could result in fewer Section 8 opt outs." It is our belief that many of the opt-outs are driven by projects that are not eligible for MUTM (ie: projects whose rents are not at 110% of FMR or more or meet other eligibility criteria established by Congress), not the process of applying for MUTM.

Page 11, last paragraph, last sentence, states, "After receiving the owners signed contract, HUD executes the Section 8 contract for one year with four (4) one-year renewals." HUD Notice H 99-36, Attachment 11A, is a Section 524(a) contract that is used by owners who enter MUTM. The contract term is five years with funding based on annual appropriations.

Page 13, Waivers, states, "HUD will consider these requests if the project meets two of three criteria". The requirement that a project meet two of three criteria was contained in HUD Notice H 99-15. The requirement was changed to read as follows in Notice H 99-36: "The property must meet at least one of these three criteria in order to be eligible for a waiver:"

Page 15 should include some discussion of HUD Notice H 00-12, issued June 29, 2000. The Notice provides detailed instructions on how to perform rent comparability studies. The guidance contained in the Notice is a result of a nine month cooperative partnership between HUD Headquarters and Field staff, housing industry partners which consisted of appraisers, and project owners. This guidance eliminates any confusion that may exist as to how to conduct a comparability study, who may conduct and review them and above all, it provides assurance that there is a uniform standard being applied to the studies nationwide. These instructions go a long way in streamlining the renewal process.

Page 17, second paragraph, second sentence states, "Owners of another 1,234 units have notified HUD of their intent to opt out of the Section 8 Program by September 30, 2001." This number is by no means a final count and owners can and do change their minds up to the last minute. HUD does everything possible to convince owners that they should renew their contracts as opposed to opting out. This includes marketing the MUTM option.

Page 18, the last paragraph on this page is referring to properties that entered into preservation contracts with the Department. In these instances, owners entered into agreements with the Department in which the Department provided additional Section 8 benefits in exchange for long-term commitments from the project owners to maintain affordable housing. The last sentence of the paragraph states, "If the owner opted out of his Section 8 contract and prepaid his insured mortgage, then additional units of affordable housing were lost." Should the owner of a preservation project elect to opt out of the section 8 contract at the end of its term, both the assisted and the unassisted tenants that qualify are issued enhanced vouchers which will allow them to remain in their units.

Page 21, second paragraph, last sentence, states, "Beginning in 1999, HUD began providing preservation vouchers to additional unsubsidized tenants at Section 236 or Section 221(d)(3) to ease the transition from capped rents to market rents." Preservation vouchers were provided to tenants of projects beginning 1995-1996 when Congress restored to profit-motivated owners rights to pre-pay their mortgages. In FY 2000, Enhanced vouchers became available to all income-eligible tenants residing in projects where the owner elected to opt out of their project-based Section 8 contract.

Page 22, second paragraph, last sentence, states, "In tight rental markets, their choices are constrained because there is very little housing available." When owners elect to opt out, eligible tenants are issued enhanced vouchers. The enhanced feature remains with the voucher holder for as long as the tenant remains in the project. However, once the tenant leaves the project, the voucher reverts to its standard status, which means that the value of the voucher declines. The Secretary recently announced the increase in the FMR from the 40^{th} percentile to the 50^{th} percentile for the 39 tightest rental markets in the country. This action will dramatically increase the pool of apartments affordable to low-income renters.

FINDING

1A. Complete Mark-Up-to-Market processing before the expiration of the Section 8 contract.

Response:

As stated in the draft report, "MUTM retains affordable housing at increased costs…" The Office of Housing believes that there is enough risk and high cost to the Government to warrant a thorough investigation prior to approving a contract for MUTM. For this reason, Field Offices are responsible for approving only those contracts that sufficiently meet the eligibility criteria. During the period of time that HUD is processing an owner's request for renewal under MUTM, owners are given a short-term contract renewal with rents adjusted by OCAF.

FINDING

1B. Expedite the decision making on waiver requests including the consideration that HUD authorize Hubs to determine whether approval of a waiver of the 110% threshold is warranted.

Response:

The Section 8 User Guide will provide further details and instructions as to what is needed in order to expeditiously process a waiver request for projects not meeting the eligibility criteria for participation in MUTM. However, as it relates to Hubs processing waiver requests, the Office of Housing has determined that, based on OGC's interpretation of the statute, during periods of limited Section 8 funding, the Department will exercise some discretion and assign "weight" to projects meeting one or more of criteria defined in the statute before a waiver is granted. In order for the Department to assign weight to these projects, a level of national tracking must be maintained. The Office of Housing has determined that the tracking will be done at Headquarters, and the discretion to assign weight to certain projects will also be maintained at Headquarters.

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FINDING

1C. Cease entering into contracts that make retroactive payments at increased rental levels to owners who do not submit their request for MUTM at the deadline of 120 days before expiration of their Section 8 contract.

Response:

The Section 8 User Guide will authorize Field Offices to deny retroactive payments at increased MUTM rent levels to owners who fail to submit the appropriate data in a timely manner.

FINDING

1D. Cease entering into contracts that make retroactive payments at increased rental levels to owners who refuse one short-term renewal.

Response:

The Section 8 user Guide will authorize Field Offices to deny retroactive payments at increased MUTM rent levels to owners who do not comply with the requirements of the program.

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Ms. Cindy Fogleman, Subcommittee on Oversight and Investigations, Room 212, O'Neill House Office Building, Washington, DC 20515 (1)

Director, Housing and Community Development Issue Area, United States General Accounting Office, 441 G Street, NW, Room 2474, Washington, DC 20548 (Attention: Judy England-Joseph) (1)

Steve Redburn, Chief, Housing Branch Office of Management & Budget, 725 17th Street, NW, Room 9226, New England Executive Office Building, Washington, DC 20503 (1)