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Senate delay could threaten housing aid

Seattle could face loss of 900 low-income units

By ERIC HOUSTON
P-I REPORTER

Two weeks after the U.S. Senate voted to delay $624 million in funding for a federal housing program, Seattle housing advocates say nearly 900 units of affordable housing in the city could be jeopardized.

The Senate voted to defer funding for the Low-Income Housing Preservation program, which is operated by the Department of Housing and Urban Development and encourages property owners to rent to low-income tenants. The House voted to allocate $200 million – about $450 million less than the previous fiscal year. A House-Senate conference is expected to meet this week to work out the final numbers.

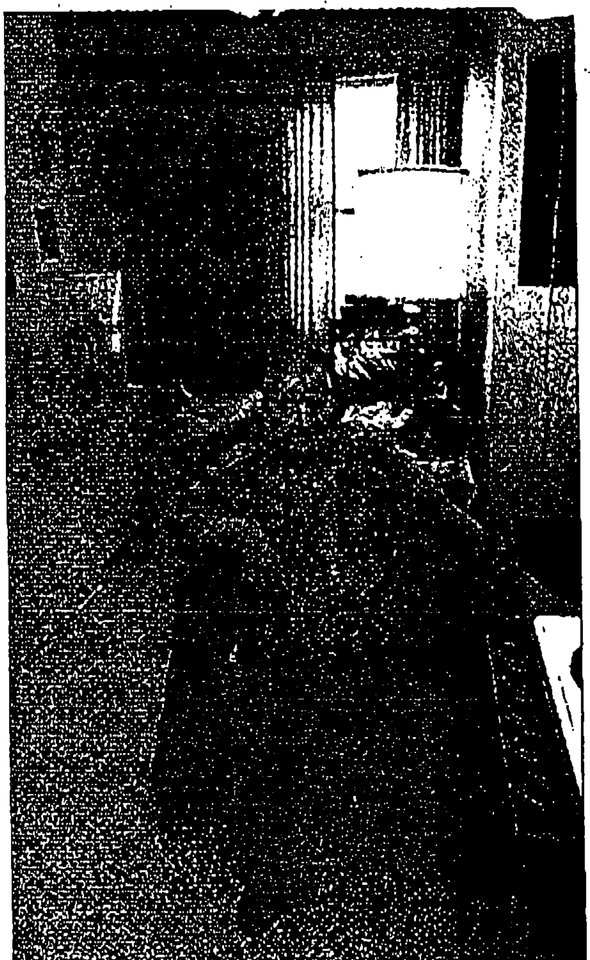
"A program that receives no funding now stands a very slim chance of receiving funding in a year," said Philippa Nye, a housing policy coordinator for the Low Income Housing Institute in Seattle. "Deferred funding means no funding forever."

Housing advocates say without continued funding, property owners could convert their buildings to market-rate sites, displacing hundreds of tenants.

But leaders of the Republican-dominated Senate disagree, saying they want to revamp the program to encourage property owners to remain in it and prevent the loss of low-income housing. They expressed concern that some property owners could opt to withdraw from the program by prepaying their mortgages.

"*Reforms* are needed – there's no question about it," said Heidi Kelly, a spokeswoman for Sen. Slade Gorton, R-Wash. "It could be very frustrating down the road if we were to have a shortage of low-income housing providers."

Kelly said Gorton favors the proposed reforms, which would offer property owners a capital grant worth 70 percent of the value of their property in exchange for staying in the housing program for 50 years. She said Gorton also favors giving tenants rent vouchers in cases where they are dislocated by property owners who decide to withdraw from the program.



LOREN CALLAHAN / P-I

Jackie Look, who has lived in the Frye Apartments for 12 years, is among those who could be forced out of his home, housing advocates say.

The preservation program gives owners of subsidized housing complexes incentives to continue operating their properties as low-income housing.

In Seattle, the 234-unit Frye Apartments in Pioneer Square and the 55-unit Atwood Apartments near Pike Place Market are among the housing sites covered under the preservation program. Tenants pay 30 percent

Housing: Many could

Housing: Many could be forced onto streets

From Page B1

of their income for rent, and HUD pays property owners the difference between that and the market-rate rent.

About $1.25 billion has been spent on the preservation program since fiscal year 1992, said Helen Dunlap, HUD deputy assistant secretary for multifamily programs. She said about $700 million would be needed during the current fiscal year to allow the program to meet the demand for low-income housing. But even the proposed House funding is far below that figure and would require taking money from other HUD programs.

"The principal concern is that there be enough resources to protect tenants," Dunlap said. If the housing preservation program is cut, she said, the Clinton administration would seek to use rent vouchers that dislocated tenants could use to find housing of their choice.

Many housing advocates have criticized vouchers, saying there is no assurance tenants will receive them or be able to use them in the private rental market.

"Vouchers are not as secure as the way it is now," Nye said. "In a tight market, someone with a voucher can't compete with someone who has money."

Housing advocates say many of the apartments threatened by the funding changes are occupied by senior citizens and people with disabilities.

Yvonne Benton, a tenant representative at the Ponderosa Apartments on 18th Avenue, said loss of the preservation program could force many people onto the streets. About 23 tenants at Ponderosa live in apartments covered under the preservation program.

"There's no place for these people to go – this is their home," said Benton, who has lived at the Ponderosa for 10 years.

Nearly 4,000 tenants in Washington state and more than 100,000 nationwide could face rent increases if funding for the preservation program is delayed for a year, housing advocates say.

"Cutting the preservation program would take away an opportunity for low-income people who have no other place to turn to for support," said Jackie Moore, president of the Laurelwood Gardens tenants association in Federal Way.

Low-income tenants fight vouchers

▶ D'Amato agrees to support federal rent subsidies. Group lobbies Walsh.

By Dan Kane
Staff Writer

Tenants in Syracuse's low-income public housing projects say they've got Sen. Alfonse D'Amato on their side in protecting federal rental subsidies.

Their next goal, they say, is to convince Rep. James Walsh, R-Onondaga, to follow the senator's lead. Walsh is on a House-Senate conference committee that will decide how the federal government will spend the rental assistance money.

"We're really not asking him to do anything that would be so radical," said Sharon Sherman of the Greater Syracuse Tenants Network. "Just follow the lead of Sen. D'Amato."

They are fighting against legislation that has passed in the Republican-led House and isn't much different from a proposal President Clinton introduced earlier this year, Sherman said.

The legislation replaces rental subsidies for low-income housing projects with vouchers that tenants can cash in anywhere. There are about 3,000 units of project housing in Syracuse that won't be guaranteed their subsidies under the House legislation, Sherman said.

The concept is that tenants will have more freedom in choosing where to live, forcing landlords to clean their apartments. But Sherman said it will bring about the opposite. As housing projects discover they don't have a dedicated source of income, they will either foreclose or try to attract middle-income tenants.

Sherman said that will dry up a market that is already lacking decent housing.

"This is particularly significant because a large number of senior citizens are in this type of housing and there are long waiting lists for senior citizen housing," Sherman said. "We need programs to continue developing more housing, and this is like (the federal Department of Housing and Urban Development) is saying, 'We're not going to do it any more. We're going to abandon this and give people vouchers.'"

The Senate bill does not include the voucher plan. A conference committee of House and Senate members is expected to begin crafting a compromise bill in the next two weeks. Walsh could not be reached for comment.

Housing advocates are also trying to convince Rep. Rick Lazio, R-Babylon, the chairman of the appropriations subcommittee, to change his position on the House bill.

Earlier this year, tenants voiced their displeasure over the voucher plan by delivering more than 20,000 signed vouchers to the White House. D'Amato joined their cause by signing one last month.

Syracuse Herald-Journal, Wednesday, October 11, 1995

Subcommittee on Housing Opportunity and Community Development
Hearing on Low Income Housing Preservation Reform

Tuesday, October 17, 1995; 10:00 a.m.; 538 Dirksen Senate Office Building

Panel One

Honorable Nicolas P. Retsinas
Assistant Secretary for Housing--
Federal Housing Commissioner
The Department of Housing and
Urban Development

Panel Two

Mr. Peter Richardson
President
Institute for Responsible
Housing Preservation

Mr. Michael Bodaken
Executive Director
National Housing Trust

Mr. Alan R. Cravitz
Developers Mortgage Corporation
Chicago, IL

Ms. Janice Niedzielski
President
Los Robles Apartments Residents
Association
Union City, CA

OPENING STATEMENT OF CHAIRMAN CONNIE MACK
HEARING ON LOW INCOME HOUSING PRESERVATION
OCTOBER 17, 1995

Today the Housing Opportunity and Community Development Subcommittee is holding a hearing on the looming crisis in the low-income housing preservation program. This hearing will address alternatives to the Low Income Housing Preservation and Resident Homeownership Act of 1990 -- LIHPRHA.

In the late 1960s and 1970s, HUD offered low interest financing to private real estate developers to build or rehabilitate affordable rental housing for low- and moderate-income families and offered owners the right to prepay their 40-year mortgages after 20 years. Prepayment would terminate both affordability restrictions and HUD regulation of the property. Faced with the specter of massive mortgage prepayments in the late 1980s, Congress embarked on the policy of preserving affordable low- and moderate-income housing and preventing the displacement of residents by providing multifamily project owners with financial incentives to avert mortgage prepayments and ending the owner's right to prepay.

Most would agree that the current preservation statute, LIHPRHA, has achieved the goal of preserving affordable rental housing for low income families and averting displacement of low-income families. But the cost of LIHPRHA is very high. It pays incentives to owners that are more generous than necessary to avert mortgage prepayment. In addition, a recent evaluation by HUD's inspector general shows that LIHPRHA has actually transformed once stable, mixed income developments into predominantly low-income housing projects that are dependent on large amounts of Section 8 assistance. Even if LIHPRHA were affordable in today's budget climate, it would have questionable merit as government policy.

But our current budget environment is forcing us to take a critical look at preservation policy. Even if we wanted to, we could not continue to fund a program that essentially preserves housing at any cost. Any alternative we select will to restore an owner's right to prepay. Our dilemma is finding a balanced alternative that will avert massive prepayments and displacement of residents, reasonably protect the long-term investment in affordable rental housing, and avoid increased financial exposure for the Federal government.

There is a clear need to act. About 1,200 projects representing 150,000 units of housing are currently in the preservation processing pipeline. Of this inventory, 18,000 units have completed the process and are awaiting funding. As many as 360,000 units are eligible for preservation. HUD has spent all of its preservation program funding. And under current law, if funding is not available for financial incentives, the owner's right to prepay is restored, and affordability restrictions are terminated. The appropriations committees are unlikely to provide new funds for preservation incentives under LIHPRHA.

(OVER)

If no alternative is developed, large numbers of owners may choose to prepay and residents -- a large percentage of whom are elderly or disabled -- could be displaced. Indeed, some in the news media are projecting large-scale displacement if a new preservation program is not enacted soon.

Alternatives to LIHPRHA range from a one-time-only "capital grant/loan" program to a prepayment/ voucher option. These proposals will be the focus of today's hearing. I want to take particular note of the contribution of our subcommittee colleague and Chairman of the VA-HUD Appropriations subcommittee, Senator Bond, who has developed a capital grants proposal that is currently included in the Senate version of the HUD appropriation bill.

Each alternative raises significant questions regarding cost and impact on tenants, communities and the supply of affordable housing. I believe any serious preservation reform should be viewed with the following concerns in mind:

- Should the Federal government continue a preservation program? And if so, how should scarce taxpayer dollars be targeted for preservation?
- How many owners will prepay their mortgages if the prepayment right is restored?
- What is the budget cost to the Federal government of various preservation scenarios?
- What is the potential for displacement of tenants under the various proposals?
- What is HUD's capacity to implement a preservation program?

We plan to look at all the alternatives carefully as we move toward the development of housing reform legislation and final action on the FY 1996 appropriation for HUD. It is important that we carefully consider our policy reform options and avoid the mistake of adopting solutions that are more costly than necessary.

I am pleased to welcome a group of distinguished witnesses to the hearing. Our first panel consists of Nicolas Retsinas, the Federal Housing Commissioner--Assistant Secretary for Housing. The second panel includes Peter Richardson, President of the Institute for Responsible Housing Preservation; Michael Bodaken, Executive Director of the National Housing Trust; Alan R. Cravitz of Developers Mortgage Corporation; and Janice Niedzielski, President of Los Robles Apartments Residents Association in Union City, California.

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FOR IMMEDIATE RELEASE:
Tuesday, October 17, 1995

CONTACT: Richard Mills 202-224-0894

OPENING STATEMENT
SENATOR ALFONSE M. D'AMATO
SUBCOMMITTEE ON HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT HEARING ON LOW INCOME HOUSING PRESERVATION REFORM
OCTOBER 17, 1995

"Good morning. I would like to commend Chairman Mack for holding this important hearing on the need for changes to the Low-Income Housing Preservation and Resident Homeownership Act and various options for its reform.

"I applaud Senator Mack for recognizing the crucial need for open discussion and debate of this pressing policy matter. Without Congressional action, approximately 150,000 low-income housing units could be lost from our nation's affordable housing stock. Therefore, it is imperative that the Housing Subcommittee continue its efforts to resolve this critical matter as soon as possible.

"I welcome FHA Commissioner Retsinas - it is always a privilege to hear his knowledgeable views. I also welcome our panel of expert witnesses, who I am sure will represent the interests of lenders, owners, the non-profits and tenants in a reasonable and balanced way.

"I must stress that the protection of existing tenants is of utmost importance. As I have consistently stated, the Federal Government has a responsibility to protect the needy poor and working class residents whom low-income housing programs are intended to serve. We also have a responsibility to protect our country's investment in the privately-owned assisted housing stock. Nationwide, 370,000 units are in the preservation inventory. Throughout this process, the rights of owners who have fulfilled their contractual agreements must be recognized justly as well.

"Given limited federal resources and the need to balance the budget within seven years, it is essential that the long-term costs of preservation be controlled. Congress, HUD and the affordable housing industry must continue to work to determine the fairest, most cost-effective way of solving this significant dilemma.

"Substantial work has been done in the development of several alternative proposals to the existing LIHPRA program, ranging from a 'capital grant/loan' program to a prepayment/voucher option. Today's hearing will allow us to assess the potential costs and ramifications of various reform solutions. HUD's limited capacity must be taken into account.

"I am in receipt of a Dear Colleague letter from twelve Members of the House, both Republican and Democrat, expressing their concerns regarding preservation. I respectfully request that this correspondence be inserted in the hearing record.

"In closing, I would like again to thank Senator Mack, Senator Faircloth, Senator Bond and all my colleagues for their dedication to addressing the many complex and difficult housing issues before us."

# # #

INSTITUTE FOR RESPONSIBLE HOUSING PRESERVATION
1255 23rd Street, NW, Suite 800, Washington, DC 20037
Telephone: 202-973-7739 Fax: 202-973-7750

President
Peter Richardson
The Boston Financial Group
Boston, MA

Vice President
Tod Spieker
Spieker Companies, Inc.
Palo Alto, CA

Treasurer
Richard A. Urban
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Richmond, VA

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Seattle, WA

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National Housing &
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Hampstead Financial
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L. Joseph Lagerbauer
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Roy Lee, III
Security Properties Inc.
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Michael J. Levitt
Michaels Development Company
Marlton, NJ

A. Thomas Spencer
Bank of America
San Francisco, CA

William. E. Szymczak
TRI Capital Corporation
San Francisco, CA

SUMMARY

of

Testimony of Peter Richardson, President
Institute for Responsible Housing Preservation

before

THE SENATE SUBCOMMITTEE ON
HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT

October 17, 1995

1. The owner's right to prepay should be restored immediately.

2. As an inducement for the owner not to prepay so that low-income housing stock will be preserved, the capital loan and grant program, as passed by the Senate, should be adopted by the Congress.

3. Funding for capital loans and grants should be available in FY 1996.

Counsel
Charles L. Edson and Stephen J. Wallace
Peabody & Brown, Washington, DC

Staff Consultant
David A. Smith
Boston, MA

Administrator
Ari M. Goldberg
Washington, DC

Testimony of Peter Richardson, President
Institute For Responsible Housing Preservation

before

THE SENATE SUBCOMMITTEE ON
HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT

October 17, 1995

Good morning, Mr. Chairman. My name is Peter Richardson. I am pleased to appear before you as President of the Institute for Responsible Housing Preservation. The Institute represents the interests of owners and managers of older assisted housing properties, and in particular those properties governed by the Low Income Housing Preservation and Resident Homeownership Act of 1990 ("LIHPRHA"). We served as the owner's voice in the legislative struggle that led to the passage of LIHPHRA in 1990 and have maintained that role ever since.

I am also a partner and vice president of the Boston Financial Group, a real estate investment company, that owns and manages more that 34,000 units of federally-assisted affordable housing throughout the country. Nearly 7,500 of these units in 44 properties were financed under HUD's Section 221(d)(3) and Section 236 programs and thus are affected by LIHPRHA.

In this testimony, we will set forth our views on the owner's contractual right of prepayment, as well as the capital loan and grant program contained in the Senate version of H.R. 2099, the FY96 VA, HUD and Independent Agencies Appropriations Bill.

We believe that present LIHPRHA is meeting the purposes for which it was enacted - preserving needed low income units, while fairly compensating the owner for taking of the contractual right to prepay. However, the LIHPRHA financing mechanism of enhanced Section 8 rents for an indefinite period of time is now deemed to be too expensive to accomplish the desired end. For that reason, the Senate, in adopting H.R. 2099, would restore the owner's contractual right to prepay while creating a new capital loan and grant program. This program would provide an incentive to encourage many owners to retain the property in the low income stock.

PREPAYMENT RIGHT

Owners strongly support the return of their right to prepay. This right was specifically included in the contracts into which owners entered at the commencement of these programs. The prepayment right was a significant inducement for them to participate in the then-uncharted waters of privately-owned federally-assisted housing.

Both the Emergency Low Income Housing Preservation Act of 1987 (ELIHPA) and LIHPRHA effectively prohibited prepayment. It was not only morally wrong for the government to abrogate its contractual promise, but the courts are now finding that it is legally wrong as well, subjecting the government to liability for damages. The Court of Federal Claims, in Cienega Gardens v. HUD, ruled exactly to that effect in March of this year. The longer the prepayment restriction stays on the books, the greater will be the damages to the government.

You can imagine how owners feel about the government's fidelity to its obligations. Originally, the government permitted prepayment. In 1990, LIHPRHA took away that right, but provides compensation for the taking involved. Then, five years later, after owners spent countless hours and dollars going through tortuous LIHPRHA processing, the government determined that it would not fund that program any longer. It is not surprising that many owners feel enough is enough.

The question is often asked, if the right to prepay is restored, will owners in fact prepay? There are those who believe that most LIHPRHA properties do not have enough real value for owners to go through the time, expense and hassle of prepayment. These doubters don't think owners would give up the security of a HUD-subsidized debt to face the unpleasant task of evicting low income tenants and then gambling on the vagaries of the conventional rental market. They believe that owners who said they would prepay -- whether there is a funded LIHPRHA program or not -- are bluffing.

We are not bluffing. Some owners will prepay in any event, and virtually all owners who have some preservation value would prepay in the absence of a viable capital grant or loan program. This is so for many reasons.

First, those of us who are managing general partners have little choice but to prepay to alleviate the current unfavorable the prepayment restriction stays on the books, the greater will be the damages to the government.

You can imagine how owners feel about the government's fidelity to its obligations. Originally, the government permitted prepayment. In 1990, LIHPRHA took away that right, but provides compensation for the taking involved. Then, five years later, after owners spent countless hours and dollars going through tortuous LIHPRHA processing, the government determined that it would not fund that program any longer. It is not surprising that many owners feel enough is enough.

The question is often asked, if the right to prepay is restored, will owners in fact prepay? There are those who believe that most LIHPRHA properties do not have enough real value for owners to go through the time, expense and hassle of prepayment. These doubters don't think owners would give up the security of a HUD-subsidized debt to face the unpleasant task of evicting low income tenants and then gambling on the vagaries of the conventional rental market. They believe that owners who said they would prepay -- whether there is a funded LIHPRHA program or not -- are bluffing.

We are not bluffing. Some owners will prepay in any event, and virtually all owners who have some preservation value would prepay in the absence of a viable capital grant or loan program. This is so for many reasons.

First, those of us who are managing general partners have little choice but to prepay to alleviate the current unfavorable tax consequences now facing our limited partners. These limited partners no longer receive any tax benefits from the investment they made 20 or 25 years ago. The tax treatments that attracted their capital have expired, and the low income use agreements with HUD prevent them from receiving any measurable cash from operations. They are not even receiving enough cash to pay their tax liabilities. Limited partners will insist that HUD financing be replaced by conventional debt financing.

Second, it is asserted that financing for LIHPRHA prepayments would not be available. Again, that is not the case. We include as an exhibit to our testimony a study by David A. Smith of Recapitalization Advisors, Inc., consultant to the Institute, which demonstrates that capital markets would emerge to provide refinancing for these projects. Lenders will look for fundamentally sound property in the private market and will do the necessary due diligence. But with the large amount of potential prepayments, we envision serious competition among financiers to make funds available for these projects. In addition, owners with strong local banking relationships would not have difficulty financing out the HUD debt.

CAPITAL LOAN AND GRANT PROPOSAL

Although a significant number of owners will prepay under any circumstances, a greater number would choose to maintain their housing as affordable stock if they receive adequate incentives. For this reason, we strongly support the new capital grant and loan preservation program contained in the Senate's appropriations act.

As under present LIHPRHA, owners would receive a loan equal to 70% of the preservation equity, as well as a rehabilitation loan. In the case of sale, purchasers would keep a property low income and receive an acquisition grant equal to 100% of the equity. Funds would also be provided for capital improvements and payment of necessary transaction costs. Because the modified program utilizes up-front funding, or installment funding over a five-year period, rather than long-term Section 8, it is cheaper than the present LIHPRHA.

Of real significance, the new program is less expensive in the relatively short run than providing vouchers in the case of prepayment. It is also far less expensive in the long run. According to a study performed by Mr. Smith, the capital grant/loan funding mechanism is slightly cheaper in seven-year outlays, about 40% cheaper in seven-year budget authority, and 64% cheaper in discounted present value over 25 years. Although we are aware of HUD's disagreement with these figures, there is no dispute that the average preservation cost under LIHPRHA is $19,000 per unit; an expenditure of that amount preserves the unit for its remaining useful life. On the other hand, vouchers needed for prepayments would cost from $6,000 to $9,000 a year. It is obvious which alternative is less costly even in the relatively short run.

The new capital grant and loan program would also permit owners who were victims of slow or non-HUD processing under LIHPHRA to participate in the preservation program. For example, legal questions on the effect of local rent control laws proved a particular problem in New York City where there has been virtually no LIHPRHA processing. Owners in Los Angeles and other areas have suffered from slow processing.

We are aware that funding of capital grants and loans does pose a first-year outlay problem. Accordingly, the Senate Appropriations Committee's bill delays the effectiveness of the program for a year. A year's delay will negate the program and exacerbate the prepayment problem and associated voucher costs. Some measure of current funding must be found. It is a mistake to concentrate on outlays instead of total long-run costs. This has been a fundamental fallacy inherent in housing finance since the United States Housing Act of 1937 when public housing was funded through annual contributions to alleviate the outlay problem, instead of up front funding. This penny-wise, pound-foolish approach has proven extremely costly to the nation and has contributed to the demise of many of our housing programs.

In any event, the owner's right of prepayment must be restored immediately. It is a matter of justice and fairness. Restoration would also eliminate the need for continued HUD LIHPRHA processing that would lead to ultimate prepayment if no funding is available. It would also mitigate damages that the government may face for breach of contractual obligations.

CONCLUSION

The Institute strongly favors the provisions adopted by the Senate two weeks ago, restoring the right of prepayment and creating the capital loan and grant program. We thank you for hearing our testimony today, and would be pleased to answer any questions that you might have.

RECAPITALIZATION ADVISORS, INC.
160 State Street, 5th Floor
Boston, Massachusetts 02109-2502
(617) 720-5855 FAX: (617) 720-3722

David A. Smith
Pamela C. Adam
Charles E. Allen
Todd Trehubenko
Kimberly A. Vermeer

10/7/95

AFFORDABLE HOUSING PRESERVATION
FINANCIAL VIABILITY OF PREPAYMENT

SUMMARY

If the right to prepay is restored, prepayment will be financially viable and there will be money available. Prepayment conversion is analogous to and no more complicated than a typical defaulted-mortgage turnaround or condo conversion, both forms for which financing is readily available.

THE ECONOMICS OF PREPAYMENT

The Typical Prepayment Candidate. A typical property suitable for prepayment has a low HUD first mortgage and current rents significantly below market levels. It has an established residential location, usually with a half-dozen older conventional apartment complexes in the same general market area; these existing properties provide excellent market comparables from which to estimate economic market rents and to determine suitable market upgrades. In the typical prepayment property, about 40% of the residents receive Section 8, usually in a form that will continue after prepayment and allow the resident to afford a significantly higher rent than the regulated rent now being charged at the property.

A prepayment conversion is substantially less risky than new construction, because there is no initial development risk and the markets are already established.

The Owner's Conversion Sequence. An owner intending to prepay so as to realize residual value will usually take the property through an eight-step sequence, as follows:

1. Obtain a conventional loan commitment for prepayment financing. As discussed below, many sources for this financing are or will be available.
2. Borrow enough money to pay off the HUD loan (plus transaction costs) and provide working capital to fund renovations.
3. Raise rents on all undercharged residents (see below).
4. Upgrade property amenities (signage, landscaping, swimming pools, and so on).
5. Raise rents on *all* apartments.
6. As moveouts occur, renovate apartment interiors.
7. Stabilize operations at the new high occupancy with market rents.

8. Take out equity by refinancing the prepayment financing into a long-term loan.

For the typical property, these eight steps will take somewhere between 12 and 30 months.

Importantly, *the entire conversion sequence can be accurately projected before the owner prepays*. Market rents are easy to estimate and verify. The current resident income profile is known, so the owner can determine in advance which residents can afford higher rents, and how much. The owner controls interim rent levels, so can stage vacancy at its convenience.

Attributes that Influence Prepayment Viability. Given the conversion sequence, the following factors influence a property's prepayment viability.

- *Rental gap* between current regulated rents and market rents. Higher gaps not only imply higher equity, they also imply potential to raise rents rapidly after conversion.
- *Current cash flow* being generated by the property, which provides Net Operating Income to service replacement debt.
- *Current cash assets* of the property, including replacement reserves, residual receipts, and other cash working capital, all of which provide funds for the transition.
- *Undercharged residents* who can pay higher rents. Because current rents are regulated, many residents are paying much less rent than they can afford, in two categories: (1) Section 8 recipients (vouchers, certificates, and existing LMSA) have contract authority to pay rent up to a payment standard that is usually FMR, and (2) low and moderate income residents currently paying far less than 30% of their income for rent. Undercharged residents comprise 50-60% of the typical property.
- *Improvements required*. Capital improvements necessary to sustain higher rents must also be financed in the conversion, and they take time to install. Thus properties in better condition, with more amenities already in place, can convert at much lower interim financing cost.
- *Remaining HUD mortgage debt* which affects how much replacement debt must be financed; lower mortgage balances make conversion easier.
- *Projected ultimate equity takeout*. Properties with large projected equity after conversion can be more easily financed, because lenders take comfort in the obvious value potential. Properties whose post-conversion value only slightly exceeds the interim financing needed will find it more difficult to locate capital.

In general, *most properties far advanced in the LIHPRHA pipeline have excellent conversion potential*. The LIHPRHA appraisal process requires a detailed, month-by-month projection of the entire conversion period. The appraisal reconciliation sequence of HUD review and reconciliation of the two independent appraisals, and subsequent owner negotiation, has had the effect of culling from the pipeline properties whose conversion potential was based on owner hope rather than market evidence.

Covering the Increase in Debt Service. The increase in debt service necessary to pay off the HUD first mortgage is small enough so that the typical property will achieve it within only a few months after prepayment.

To pay off the typical HUD loan and replace it with conventional financing requires an increase in initial debt service of roughly $54 per apartment month (from roughly $36[1] before prepayment to $90[2] after prepayment). The owner will have several sources to cover this funding:

- Current cash flow already being generated. The typical property generates about $9[3] per apartment per month.
- Existing cash assets (replacement reserves and residual receipts). The typical property has about $500 per apartment in these accounts.
- Immediately achievable rent increases from undercharged residents. An increase of as little as 14%[4], if sustained throughout the property, would cover the necessary debt service.
- Internal funding from the prepayment loan, in a manner similar to construction loans.

In this regard, prepayment conversion is obviously analogous to and less complicated than condo conversion, turnaround, or new construction of conventional rental apartments (or LITC properties, which are an even better analog), all of which have had financing vehicles established for many years.

AVAILABILITY OF PREPAYMENT FINANCING

Today's capital markets are extraordinarily efficient, and their demand for new financial products appears insatiable. Lenders seeking new outlets have become attracted to all aspects of the HUD portfolio, from property disposition through non-performing loans. Recent HUD auctions have established that even complicated and underperforming assets can be packaged into pools and rapidly financed -- indeed, the expectation of rapid financing for defaulted HUD assets is a cornerstone of HUD's proposed mark-to-market recapitalizations.

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[1]Calculated assuming a typical Section 236 property with $12,000 per apartment of remaining HUD debt, bearing interest at 7% (which results in a monthly debt service payment of $93), and receiving $57 in monthly Section 236 interest reduction payments (IRP) that reduce the debt service to $36 per month, the amount that would be paid if the mortgage bore interest at 1%.

[2]Calculated as in the preceding footnote, using $12,500 per apartment ($12,000 of mortgage payoff plus $500 in transaction costs), at 9%, interest-only until converted into a permanent loan. The 9% interest rate chosen is higher than current market conditions.

[3]HUD regulated properties are entitled to a 'limited dividend annual distribution' equal to 6% of imputed equity (10% of HUD-approved cost, with the original mortgage covering 90% of approved cost). Using the same $12,000-per-apartment balance today (which implies an original mortgage of $15,300], the original equity was $1,700 ($15,300 / 90% * 10%) and the typical limited dividend is $102 per year, or $9 per month.

[4]Calculated as $54 required increase divided by $374 average monthly rent now being achieved.

Lenders approaching prepayment conversion loans will finance them using the same underwriting principles applied in new construction, turnaround, or condo conversion. They will want several features:

- *Fundamentally sound property* capable of competing in its local market (after turnover of the residents).
- *Thorough due diligence* applied by experts in affordable housing finance and operations.
- *Interim security* for the negative carry period in the form of guarantees from the borrower, additional collateral, or a low loan-to-value ratio (on the economic value after conversion).
- *Yield* commensurate with the conversion risk. This will typically reflect itself in the proposed borrowing rate. Capital markets have demonstrated extraordinary efficiency in pricing securities across a risk spectrum.

Owners can find prepayment loans today on a local or regional basis; such lenders know their markets, know the properties, and have established long-term banking relationships with the developer general partners who will be soliciting the loans.

Nationally no vehicle is yet available, largely because no market yet exists. (The right to prepay was rescinded in 1987 and has yet to be restored.) However, if the right to prepay is restored and no attractive preservation program is available, then the volume of potential business will be sufficiently large that it will attract securitization interest within a few months.

The best evidence that financing will be available is the initial HUD non-performing loan auction. Before HUD offered these loans for sale, no market for such loans existed. Yet, within the space of only a few months, a dozen major bidders emerged, leading to a spirited auction that yielded HUD more than $700 million in mortgage recoveries. Prepayment properties are superior candidates for securitization because they are *not* financially or operationally distressed and their mortgages are current; owners will *elect* to prepay and will have plenty of opportunity to configure their property before prepayment to maximum advantage.

Prepayment Pro-forma for a Typical Property. Exhibit 1 illustrates the prepayment conversion sequence for a typical property (all figures are per-apartment and use estimates that we believe fairly reflect the LIHPRHA pipeline as a whole). In addition to paying off the $12,000/apartment, the property would also require renovations for required repairs and competitive upgrades, which to be conservative are estimated at $5,000/apartment[5].

Even assuming a high rate of turnover, and a relative inability to raise rents on undercharged residents, this sample property achieves positive coverage (that is, NOI after prepayment greater than debt service on the prepayment loan) within nine months of prepayment. Total 'negative carry' (interest obligations greater than Net Operating Income) is only $400 per

[5]According to HUD statistics, the average required repairs for all approved Plans of Action in the LIHPRHA pipeline so far averages about $1,500 per apartment for extensions, $5,000 per apartment for sales, for an overall average of about $2,500 per apartment. To this must be added the competitive upgrades unnecessary for continued affordability but important if the property is going to compete for market-rate residents.

apartment, a small amount (less than 3% of the total loan required) easily financed either from existing working capital (such as replacement reserves and residual receipts) or in the prepayment conversion loan

After nine months of negative carry, the property starts generating more cash flow than its new loan needs, so that, when the renovations are completed twelve months after prepayment, the interim financing can actually start being slowly amortized, even as the property continues to raise its earning power in anticipation of an eventual equity takeout. (These results are also shown graphically, month by month, in Exhibit 2.)

Slightly more than two years after prepayment, the owner is in a position to finance a permanent takeout. Even assuming conservative undertaking (125% coverage on achieved rents with no forward projection), the owner of our sample property can refinance to pay off the prepayment loan, pocket $6,500 per apartment in net refinancing proceeds, and remain with a substantial cash flow worth another $6,000 per apartment.

In other words, *an owner evaluating prepayment should expect $12,400 per apartment in net equity, even after paying all renovation, transition, and financing costs of the conversion.*

Financing considerations. This typical example illustrates that the financial risks of prepayment are frequently overstated. This property covers its new debt service only nine months after prepayment with operating losses equal to only about 3% of the loan. Moreover, the interim cash flow projection can be refined by a careful examination of the resident rent roll and subsidy configuration to determine how many residents are undercharged (in a market sense) and thus how much of a rent increase can be implemented immediately.

Comparing prepayment with preservation recapitalization. Of course, an actual conversion entails various risks to lenders (who will want guarantees, collateral, or upside participation) and owners (who will have to supply guarantees or collateral). Thus, most economically rational owners who have the option to choose between conversion and a fair preservation recapitalization (such as current LIHPRHA or a capital grant/loan funding mechanism) will probably elect the safer route of preserving their property.

For this reason, we believe that *if* Congress restores the right to prepay and simultaneously reforms LIHPRHA without compromising its fundamental economics (such as with the capital grant/loan proposal now passed by the Senate), *then* owners far advanced in the LIHPRHA pipeline will generally accept preservation. On the other hand, if prepayment is the *only* avenue to realize value, then owners will pursue it vigorously.

If prepayment becomes the preferred approach for a large body of owners, there will be sufficient demand to motivate securitizers and other large capital sources to create a vehicle by which to finance prepayments, conversions, and equity takeouts. Experience shows that the process of designing and going effective with a new financing vehicle will take 2-6 months, as shown by the volume of interest surrounding recent HUD auctions of non-performing assets.

CONCLUSION

Properties with economic conversion potential should have little difficulty securing financing, because the cost to pay off the HUD mortgage and escape HUD rent regulation is small compared with the projected equity value after conversion.

Economically rational owners of properties capable of either prepayment or preservation will generally elect preservation so long as it is fair and reasonably likely. However, if preservation is eliminated and the right to prepay restored, most owners will unhesitatingly elect to prepay.

Owners seeking prepayment will be able to find financing either locally (based on relationship banking or additional local collateral) or nationally (through to-be-created mortgage lending pools). Prepayment is economically analogous to condo conversion or turnaround, and less risky than either; thus we expect that financing sources would rapidly arise to exploit the opportunity that will become available if preservation is eliminated and owners are again allowed to prepay.

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10/07/95

Financial Viability of Prepayment
Typical Property Conversion

All figures are per-apartment.	Month of prepayment	Prepayment + 6 months	Prepayment + 12 months	Prepayment + 18 months	Prepayment + 24 months	Prepayment + 30 months
Gross Potential Rent (annualized)	4,485	5,827	6,819	6,956	7,097	7,240
Vacancy	3.0%	25.0%	13.0%	7.0%	7.0%	7.0%
Total income	4,350	4,370	5,932	6,470	6,600	6,733
Operating expenses (annualized)	3,780	3,795	3,747	3,822	3,899	3,978
Net Operating Income	570	575	2,186	2,647	2,701	2,755
Required debt service on prepayment loan	465	1,291	1,520	1,515	1,462	2,014
Coverage on current debt service	123%	45%	144%	175%	185%	137%
Total financing outstanding	12,000	14,825	17,253	16,742	16,145	22,373
Owner's annual cash flow after financing	105	0	666	1,132	1,238	595
Owner's remaining equity (at 10%	1,051	0	6,656	11,320	12,383	5,949
Implied property value (debt and equity)			23,908	28,062	28,528	28,322

Narrative Interpretation

Coverage on current debt service is the ratio between the property's annualized Net Operating Income and the debt service required on the prepayment financing. As the schedule shows, for a few months after prepayment, the property has 'negative carry' (it is generating too little income to cover the full debt service, but by the end of twelve months, the property has ample additional cash flow. The equity takeout refinancing is projected to occur in Month 27. When it happens, the new loan will b $22,600 per apartment, which will pay off the prepayment loan (by now risen to $15,900, leaving $6,500 in refinancing proceeds. After this, the owner will have about $600 per year in cash flow, worth another $5,900 in owner's retained equity, so this owner has an aggregate equity, before prepayment, of about $12,400 per apartment.

Conclusion: This property can finance its prepayment and yield the owner an equity of $12,400 per apartmen

Principal Assumptions

$12,000 Current HUD mortgage per apartment, Section 236, with *7.0%* interest rate, *19* years left to go.

$5,000 Capital improvements per apartment required to make the property conventional.

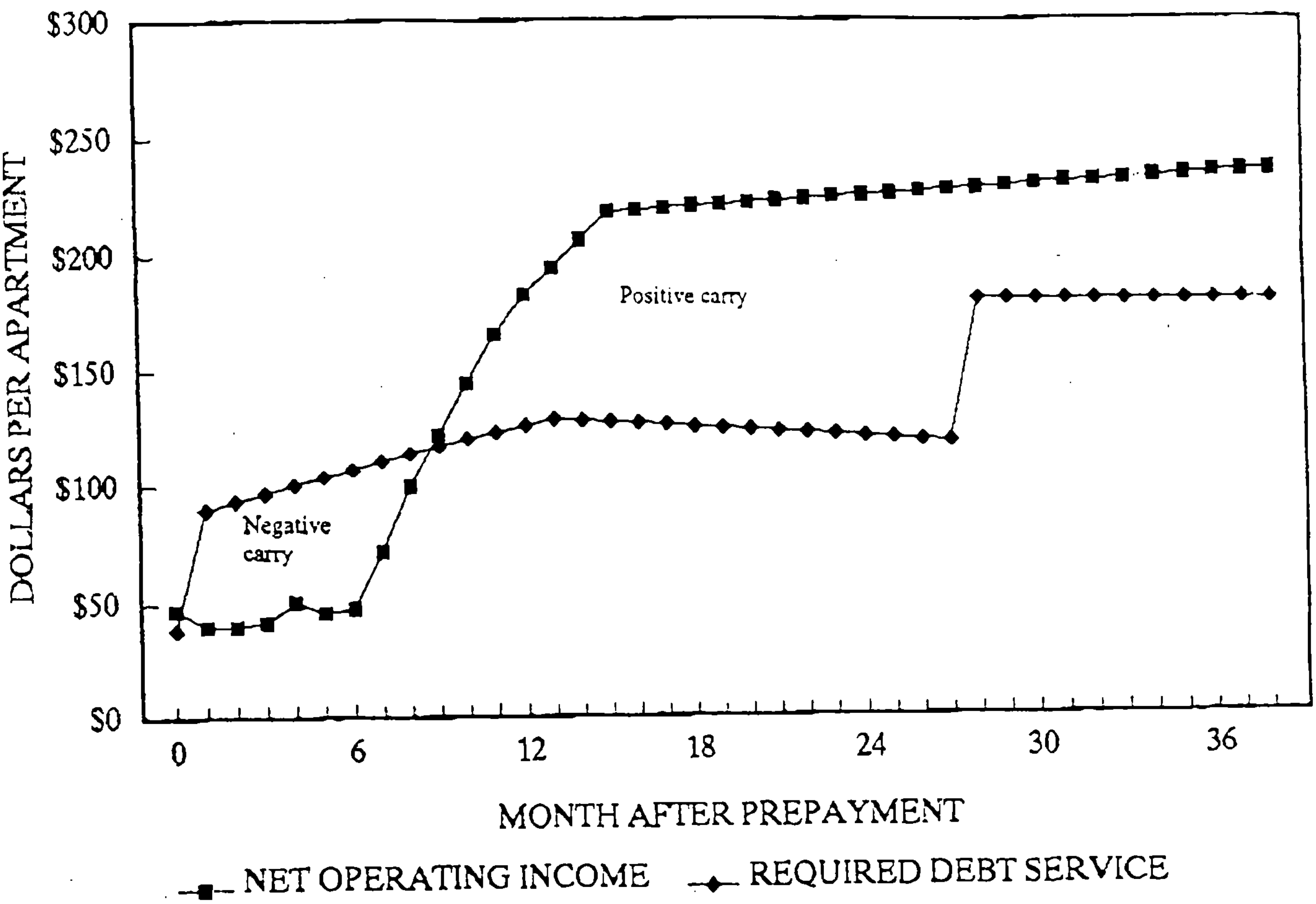
Average current HUD rents o *$374* per apartment, which are *68%* of property's market rents of $546

Current operating expenses of $3,780 per apartment will drop to $3,600 per apartment when stabilized.

Replacement financing available at an interest rate of *9.0%*, interest-only during conversion, then refinanced at equity takeout with a *30*-year term anc *125%* required coverage ratio.

VIABILITY OF PREPAYMENT

CONVERSION PERIOD PROJECTION



This graph illustrates the prepayment conversion period month-by-month, showing how Net Operating Income (the line of ■ symbols) compares with the debt service required on the prepayment loan (the line of ◆ symbols).

When the HUD mortgage is prepaid, debt service required jumps immediately but income rises more slowly, because even though the owner will raise rents promptly, higher-than-normal vacancy will arise as the apartments turn over. Within a few months, Net Operating Income (NOI) starts to rise substantially, so that by Month 9 the property is paying its prepayment debt service. By Month 15, NOI has risen to generate significant interim cash flow. After a year of this, in Month 27 the owner is capable of funding an equity takeout.

Principal assumptions used to generate this graph are:

- HUD mortgage of $12,000 per apartment, Section 236
- Market upgrades and required repairs of $5,000 per apartment
- New borrowing at 9%, interest only until refinanced, when it converts to self-amortization.
- Equity takeout refinancing after 12 months of stabilized operations using 125% coverage.

The owner's projected equity takeout is $6,500 per apartment, plus $6,000 in capitalized value of remaining cash flow, for an equity *before prepayment* of about $12,500 per apartment. Aggregate negative carry (interest that cannot be paid from operations) is about $400 per apartment, and aggregate positive carry (cash flow during conversion above current debt requirements) is about $1,550 per apartment.

Recap Advisors, Inc./ 160 State Street, 5th Floor/ Boston, MA 02109/ Tel: (617) 720-5855/ Fax: (617) 720-3722

SUBCOMMITTEE ON HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE

October 17, 1995

Written Testimony of Alan R. Cravitz
Regarding Pre-Payment of the Affordable Housing Inventory and the Impact on Tenants

In 1988 the National Low Income Housing Preservation Commission, co-chaired by Carla A. Hills, Former Secretary of the Department of Housing and Urban Development, and Henry S. Reuss, Former Chairman of the Housing Committee on Banking, Finance and Urban Affairs, submitted a report to the House Subcommittee on Housing and Community Development and the Senate Subcommittee on Housing and Urban Affairs titled *Preventing the Disappearance of Low Income Housing*. The Commission examined the portion of the privately owned, low-income stock consisting of "properties that HUD subsidizes and whose mortgages the FHA insures", specifically those properties receiving "support pursuant to the Section 221(d)(3) Below Market Interest Rate Program (BMIR), Section 221(d)(3) Market Rate (MR) Program with rental assistance and the Section 236 Program." The Report refers to those properties as the Preservation Analysis Inventory and has come to be known in industry jargon as "preservation projects".

The 135-page report reached many thoughtful conclusions using a comprehensive economic model to analyze significant amounts of data on the Preservation Inventory. Specifically, "the economic model simulated the most likely action of owners vis-a-vis their decision on the disposition of their property and the potential effect on tenants". The model projected that "66 percent of the for-profit owners eligible to pre-pay will do so" - - - predicting that 243,000 units will pre-pay their mortgages between 1988 and 2002, converting these formerly subsidized rental units to market rate rental housing or other uses.

The passage by Congress of the Emergency Low Income Housing Preservation Act in 1987 (ELIHPA) and the Low Income Housing Preservation and Resident Homeownership Act in 1990 (LIHPRHA) have prevented us from establishing the accuracy of predictions in the Report. Both Acts essentially prevented owners from pre-payment and offered as an inducement certain "incentives" to retain the low-income character of the projects. We now revisit the question: Would owners of the preservation projects pre-pay and terminate affordability restrictions? And, if so, what is the effect of pre-payment on current and future tenants?

As a mortgage banker in Chicago for the last twenty years specializing in multifamily rental housing, I have specific and personal knowledge of virtually all of the preservation transactions that have taken place in the Chicago market area. Specifically, I am going to discuss transactions in two communities in the City of Chicago, Lincoln Park and Uptown. I have chosen these communities not only because of the large number of transactions that have taken place in these areas, but also because they represent two very different kinds of communities, one an established area which has long since gentrified and the other a transitional area which until very recently could best be described as a problem area characterized by substandard housing conditions, transient population and high crime rates. I focus on these areas to show that owners will pre-pay mortgages not only on projects in the more desirable areas, but in more marginal or changing areas as well. This conclusion would be no different (maybe even more obvious) if the sample considered the Chicago suburban market area and I have no reason to believe that this pattern would be different in many other parts of the country.

Attached as Exhibit Nos. 1A and 1B are maps of the two community area(s) showing sixteen (16) projects developed in the 1960's and 1970's under the 221(d)(3) BMIR and 236 Programs. The projects are divided into three (3) categories:

I. Projects in the market area(s) pre-paid prior to enactment of ELIHPA (1987);

II. Projects currently in process under the Preservation Program or awaiting funding; and

III. Projects preserved under ELIHPA/LIHPRHA.

Attached as Exhibit No. 2 is a chart listing each of the projects shown in I and II on the maps in Exhibit Nos. 1A and 1B. This exhibit shows current rents at both the pre-paid projects and those still in the preservation inventory, as well as projected market rents for the preservation inventory upon pre-payment. Exhibit No. 2 also includes appraisal values and other relevant information taken from the appraisals conducted during the LIHPRHA appraisal process.

We start by examining the two (2) projects in Category I, projects that pre-paid and terminated all use restrictions prior to the enactment of ELIHPA in 1987. As one can see, current rents in these two projects are significantly greater than the current rents for the projects in Category II, those projects still subject to rental affordability restrictions. It is worthwhile stressing the point that rent levels increased dramatically and that the increase caused the displacement of the tenants who occupied the properties before pre-payment.

The 533 Barry project (which pre-paid its loan in 1986) had undergone a moderate renovation after pre-payment and was sold in 1994 for approximately $11.0 million (nearly six times the unpaid principal balance of the HUD subsidized mortgage when the it was pre-paid). The 1994 acquisition was financed under a State Agency Program designed, ironically, to allow some or all of the rental units to be affordable to low income tenants - - - in this case 26% of the units were designated as affordable. The 833 Buena building pre-paid its loan in 1988. Extensive and costly litigation followed and the owner was able to raise rents to market levels in 1991. Upon pre-payment the income profile of the tenancy changed from low and very low to moderate and upper income tenants and, even though HUD provided certificates and/or vouchers to all tenants residing in the project at the time of pre-payment, there are currently no certificate and/or voucher tenants in the building.

The consequence of the pre-payment of these two projects, the 533 Barry project in the Lincoln Park community and the 833 Buena project in the Uptown community, was the loss of 371 units to the affordable housing supply and a significant increase in rents at both projects that displaced the low income residents from the properties.

We now look at the projects listed in Category II - - - those currently subsidized projects which have a Plan of Action to retain affordability either in process or awaiting funding. I would like to point out that for each of these preservation projects the current rents are less than the market rents established in the HUD and owner appraisals and that the appraisal rents are roughly twice the current rents charged at the properties (Section 236 basic rent).

In addition to the significantly higher market rents, the appraisals (even the more conservative ones prepared by HUD or independent third appraisers under LIHPRHA) show values substantially higher than the outstanding mortgage balances. Also, it is worth pointing out that in two instances, the appraisals established the "highest and best use" as condominium conversion and in a third appraisal HUD recognized the "highest and best use" as upscale retirement housing. Therefore, not only would owners of these projects pre-pay their subsidized loans but would possibly remove these properties from the rental housing inventory entirely.

The Park West Towers project in Lincoln Park represents an interesting case. This project was financed by the State Agency with 30% of the units subsidized by Section 236 interest subsidy payments. The owners of Park West have already filed a notice to pre-pay and, therefore, it is safe to assume they intend to pre-pay. The project is a prime candidate for condominium conversion as soon as LIHPRHA restrictions are lifted.

The Subcommittee, I'm sure, has heard testimony to the effect that most owners will not pre-pay even if the legislation is changed to allow pre-payment. What such statements fail to recognize is that owners may not pre-pay immediately, but within the next two or three years many owners will select this option. The following arguments support this contention:

1. Many owners will pre-pay to relieve themselves of the HUD bureaucracy;

2. In many parts of the country, the Chicago area is certainly one, market rents are starting to increase dramatically as rental markets tighten and vacancies decline as the oversupply of units constructed in the mid 80's has been absorbed. In the City of Chicago and its suburbs virtually no new rental housing is under construction. The Chicago HUD Office, once one of the leading HUD Offices in financing new construction of market rate rental housing, is currently processing one loan application for new construction rental housing and has not financed any new market rate rental housing for at least five years. As market rents increase the motivation to pre-pay loans and raise rents on projects in the current affordable housing inventory will intensify;

3. Most projects in the preservation inventory have modest loan balances compared to the project values. The projects in Exhibit II illustrate this point with the average remaining debt of $15,000/unit and average market value of $45,000/unit for the properties. With current low interest rates providing attractive refinancing options, owners can in many instances pre-pay the HUD subsidized loans with the current project cash flow. (Of course, once the projects have been de-regulated the owners will be free to raise rents to generate additional returns);

4. Even though we keep referring to the pre-payment inventory as having twenty years "to go" before the loans are paid off, in fact, many of the loans have much shorter loan terms remaining. Some of these owners may just allow the short term HUD subsidized loans to fully amortize and convert the units to market rate housing at that time;

5. Many of the projects in the preservation inventory had been re-syndicated in the early 80's using secondary financing secured by partnership interests in the project. Ownership of these properties reverts to the second note holders if current owners are unable to pay off the second note at maturity. Therefore, an owner will be under serious pressure to pay off the HUD-insured first mortgage and refinance the entire transaction to satisfy all or part of the secondary debt or risk the loss of the project to the second note holder with disastrous tax repercussion. (If the second note holder does takes back ownership of the property, we are faced with the circumstance, once again, of a pre-payable property with a low mortgage balance.);

6. Owners may refinance to mitigate "phantom" income problems; and

7. Once loans on the preservation inventory can be pre-paid, new owners will acquire the inventory with the purpose of pre-paying the HUD-insured mortgages and converting the project to some kind of market rate use - - - this is the Park West Towers example mentioned earlier. I have already received numerous calls from potential buyers asking when "LIHPRHA will be over" so that they can purchase and de-convert a particular family

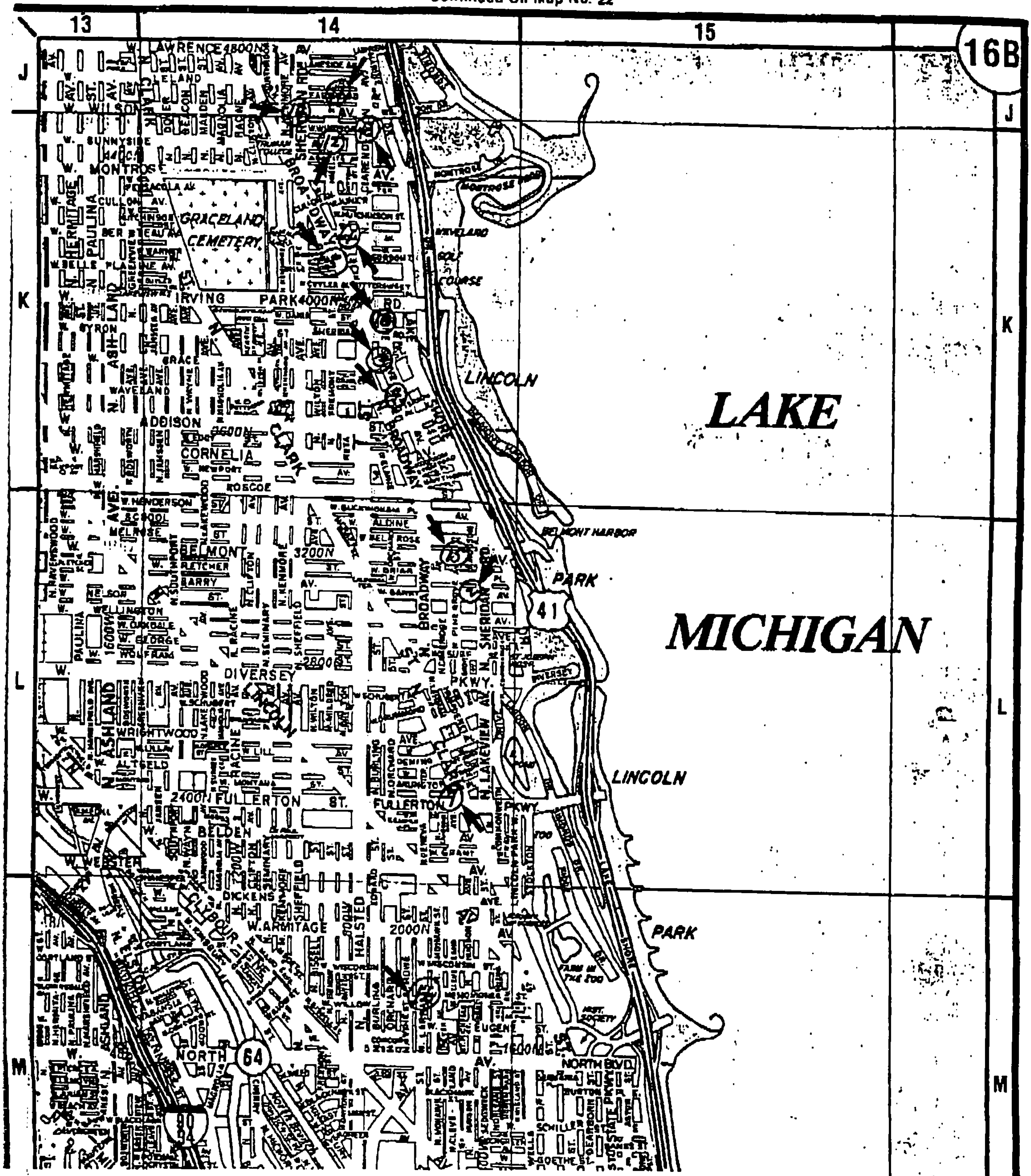
or elderly subsidized project.

I do not want to leave the Subcommittee with the impression that "every" owner of "every" property in the preservation inventory will pre-pay loans and increase rent levels. For various reasons, some owners will decide to stay with the program. (One of my fears is that owners of the less desirable real estate located in low income areas will remain in the program, while owners of properties in more modest to upscale communities will pre-pay.) In order not to provide "incentives" to those owners who would not pre-pay, the Subcommittee could consider a minimum value threshold for which projects would be eligible for "incentives". In any event, many owners will pre-pay and the housing which the government helped build and subsidize for over twenty years will be lost to the inventory. I believe that owners could be convinced to retain this housing as affordable if given a choice of a straight forward, workable "preservation program".

Some have proposed allowing voluntary pre-payment "protecting" the tenants simply be providing vouchers. While this proposal presents a number of policy considerations, I would like to address this proposal from a mortgage banking perspective. I believe it is unrealistic to expect lenders to provide financing to projects relying on vouchers as the source of project income. (I have even been unable to convince HUD to finance such projects.) Therefore, I do not believe that many owner wishing to pre-pay will be able to retain current tenants with vouchers. Much has been said about relief from the "take one, take all" provision. However, it will still be lawful to take none. It is my expectation that the majority of owners will follow the 833 Buena example and refuse to accept tenant based assistance. It should also be noted that vouchers are of no utility in projects converted to condominium or other non-rental uses.

As one final thought, a strong economic argument can be made for preserving the existing housing stock - - - it is significantly less expensive to pay to keep the current subsidized housing than to provide new "affordable" units using other Federal programs (e.g., HOME, low income housing tax credits, tax-exempt financing, et al.) Some clients recently asked if I could finance the renovation of an old hotel building in a downtown Chicago suburb to be used for elderly housing. The cost of the proposed 57 unit development was approximately $6,000,000 or approximately $100,000/unit - - - unfortunately, not an unrealistic budget. Meanwhile, in the same suburb, I am processing with HUD a Plan of Action for the sale of an existing 231-unit elderly housing project to a not-for-profit group for a total preservation cost of approximately $8.0 million or approximately $35,000/unit - - - ⅓ the cost of the new development. Although we need to build new affordable housing units as the demand increases, it is equally important and much less expensive to retain the current affordable housing inventory.

Continued On Map No. 22



I. Projects in Market Area(s) Prepaid Prior to Preservation

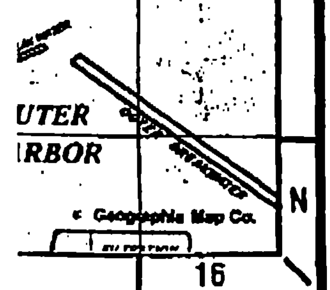
1. 833 West Buena
2. 533 West Barry

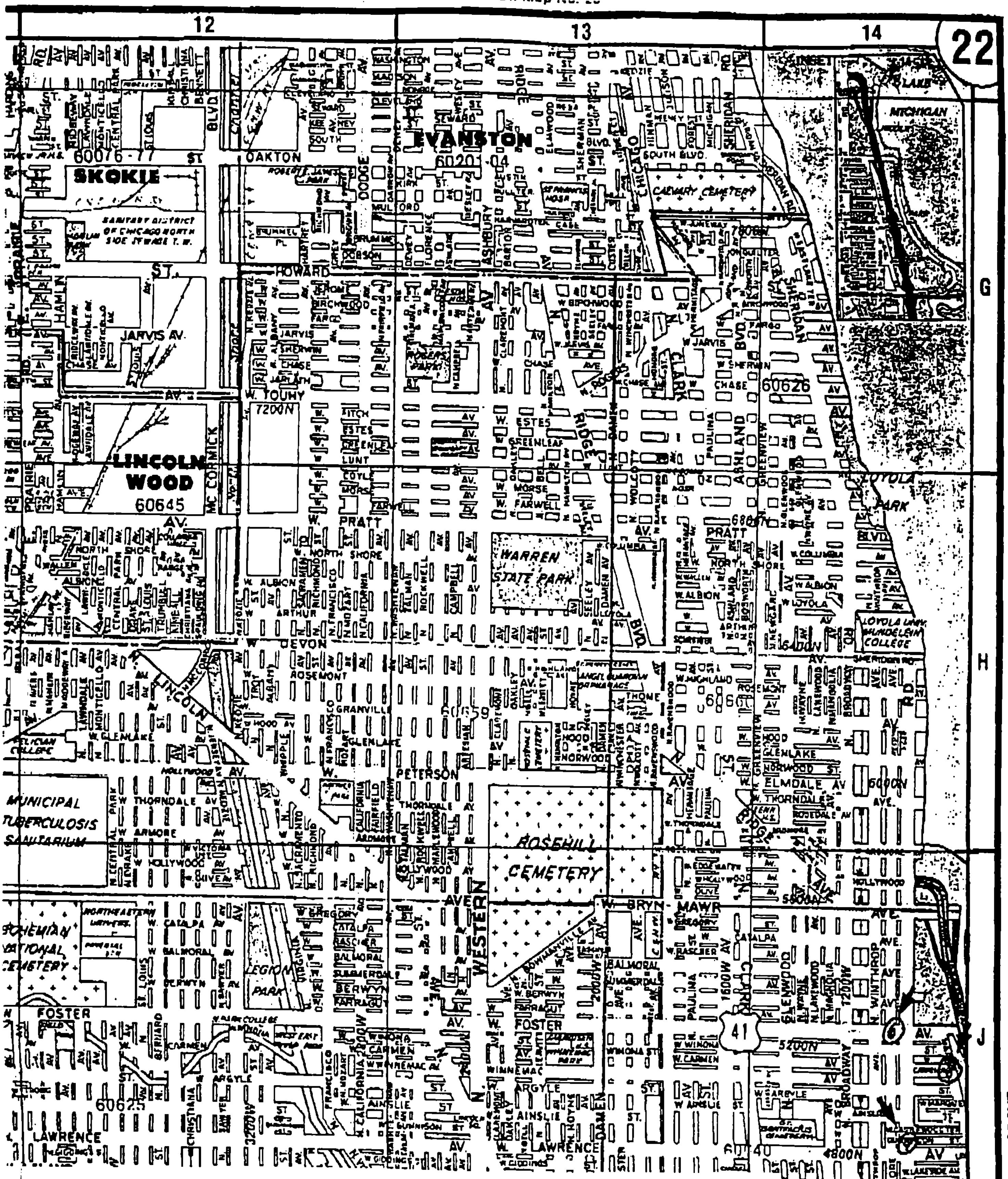
II. Projects Currently in Process Under Preservation Program in Market Area(s)

3. 635 West Grace Street (elderly)
4. Pine Grove/Waveland Apartments
5. 820 West Belle Plain Apartments (approved pending funds)
6. 5200 North Kenmore (elderly) (approved pending funds)
7. Park West Towers

II. Project Preserved Under ELIHPA/LIHPRHA

8. Carmen-Marine Apartments (resident purchase)
9. Sheridan-Gunnison Apartments
10. Pine Grove Apartments
11. 650 West Eastwood
12. 640 West Sunnyside
13. 4550 North Clarendon (non-profit purchase)
14. 4640 North Sheridan (non-profit purchase)
15. 510 West Belmont
16. West Park Apartments (resident purchase)





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2. 533 West Barry

III. Projects Currently In Process Under Preservation Program in Market Area(s)

3. 635 West Grace Street (elderly)
4. Pine Grove/Waveland Apartments
5. 620 West Belle Plain Apartments (approved pending funds)
6. 5200 North Kenmore (elderly) (approved pending funds)

II. Project Preserved Under ELIHPA/LIHPRHA

8. Carmen-Marine Apartments (resident purchase)
9. Sheridan-Gunnison Apartments
10. Pine Grove Apartments
11. 850 West Eastwood
12. 840 West Sunnyside
13. 4550 North Clarendon (non-profit purchase)
14. 4640 North Sheridan (non-profit purchase)
15. 510 West Belmont
16. West Park Apartments (resident purchase)

R-98%

[redacted]

Exhibit No. 2

	Current Rents	Appraisal Rents HUD	Appraisal Rents Owner	Comments
I. Projects in Market Area(s) Pre-Paid Prior to Preservation				
1. 833 West Buena				
84 1BR	$600-$635			Project currently 97% occupied; Additional $60/month charge for parking space: no voucher or certificate holders in building.
84 2BR	$700-$740			
42 3BR	$800-$900			
210				
2. 533 West Barry				
64 1BR	$745-$785			Project recently refinanced under State Agency Program to provide 26% affordable units. Parking additional $120/month. Building 100% occupied.
64 2BR	$995-$1095			
33 3BR	$1255-$1295			
161				
II. Projects Currently in Process Under Preservation Program Market Area(s)				
3. 635 West Grace Street (elderly)				
36 Studios	$325-$374	N/A	$650	Appraisals as of November 1994 Final values not established Owner's appraisal indicates highest and best use as Retirement Housing (not rental housing)
144 1BR	$368-$486	N/A	$800	
180				

	Current Rents	Appraisal Rents HUD	Appraisal Rents Owner	Comments
4. Pine Grove Waveland Apartments				
68 1BR	$404-$415	$680		Appraisal as of March 23, 1995
				Appraised Value Capital Needs (Condominium) - $11,724,400
84 2BR	$479	$808		Appraised Value (Rental) - $11,093,000
				Current Mortgage - $3,667,857
17 2BR	$495	$933		(not including Parking, commercial income)
17 2BR	$496	$968		
34 3BR	$552	$1,023		
220				
5. 820 West Belle Plaine Apartments				
46 Studio	$374-$388	$540	$600	Appraisals as of December 1993
				Capital Needs $613,400
134 1BR	$436-$459	$650	$765	Appraised Value (Condominium) - $16,060,000
				Appraised Value (Rental) - $13,300,000
92 2BR	$505-$514	$875	$975	Current Mortgage $3,750,000
				(Parking fees of $60/$70 not included)
272				
6. 5200 N. Kenmore (elderly)				
54 Studio	$295	$550	$575	Appraisal as of November 7, 1994
				Capital Needs Assessment - $103,260
54 1BR (Conv.)	$362	$650	$750	Appraised Value - $12,250,000
162 1BR	$350-$370	$680	$750	Current Mortgage - $4,900,000
				(Parking fee not included)
54 2BR	$418	$825	$950	
324				
7. Park West Towers	Not Available			

STATEMENT
TO
SENATE SUBCOMMITTEE ON HOUSING OPPORTUNITY
AND
COMMUNITY DEVELOPMENT

BY

JANICE NIEDZIELSKI
RESIDENT
LOS ROBLES APARTMENTS
UNION CITY, CA

HEARING ON HUD'S MULTIFAMILY HOUSING PRESERVATION PROGRAM

OCTOBER 17, 1995

BIOGRAPHY

JANICE NIEDZIELSKI

Janice Niedzielski is a single mother in her mid-40's who has raised two sons. She has lived in LOS ROBLES APARTMENTS, in Union City, CA, a HUD-subsidized complex, for the last 10 years. She has a high school education and a diploma from Western Career College's medical secretary program. Before she was fortunate enough to get an apartment at Los Robles, she and her children had moved from one apartment to another, from one friend to another, then to a one room camper trailer in a storage yard, then to her car. She has always been employed and has supported herself and her two children. With wages being as low as they are, and rents being as high as they are in her area, she was paying well over 50% of her income toward rent. Qualifying for an apartment at Los Robles was a godsend and gave her the opportunity to raise her family in a stable, clean and safe environment.

In November of 1994, Ms. Niedzielski and the other residents of Los Robles were given a "notice of intent" to sell by their owner under the Title VI, LIHPRHA program. She helped organize a steering committee and was voted in as President of Los Robles Resident Organization. With her leadership, the committee interviewed and selected a consultant team and an established non-profit housing corporation co-sponsor to purchase the project. Together they drafted and submitted a purchase agreement to the owner. She has been outspoken in favor of the need for the preservation program, which allows residents to keep affordable housing and gives them a voice in the ownership and operation of the complex.

Statement of Janice Niedzielski

Resident of Los Robles Apartments
Union City, California

to

Senate Subcommittee on Housing Opportunity and Community Development

Let me start by saying thank you for this honorable opportunity to testify today on the need for a preservation program.

I am hoping you are all aware that the homeless population in America is growing daily and the decisions you make in these chambers affect real people, not just dollar amounts on a budget. In the package I've handed you, you will see the faces of the people who could be added to the population of homeless Americans if there is no preservation program. The people who will be displaced if you eliminate preservation and allow owners to prepay their mortgages and sell their complexes on the open market.

Some people think HUD-subsidized housing complexes are slums. As you can see in the pictures, Los Robles is a clean, well-maintained complex consisting of 140 units. It is the only HUD-subsidized complex in Union City. The people in these units are seniors, families and disabled citizens from many different ethnic backgrounds. Incomes range from very low, to low and moderate. This is one of the few places in Alameda County that allows the low-income families in the 3, 4 and 5 bedroom units to have a safe, healthy, affordable living environment.

I understand that you want to make changes in the preservation program, but I hope you will do it in a way that is not a hardship for residents. Los Robles and similar projects across the country have three choices, which are:

1. Allow the owner to prepay and give the residents vouchers. This option stinks and will eventually lead to displacement. At Los Robles, 140 families would be disrupted, many will end up homeless. There are three reasons:

   a. As you can see by the newspaper rental ads, vacancy rates are very low in Union City, and there are virtually no 3, 4, and 5 bedrooms in the surrounding area. A voucher is useless if there are no units available.

   b. Many owners will not accept vouchers. Included in the package are rental ads stating they will not accept Section 8 vouchers. There is nothing written that says they must accept them and, if there were, enforcement would be weak and spotty.

   c. It is our understanding vouchers will only be for 1 - 2 years. What will these families do after that?

2. Allow the owner to prepay and build replacement units in the area. I'm no expert, but it would seem to me that preserving Los Robles and similar projects rather than replacing them would make more economic sense.

3. Preserve Los Robles and similar projects with a Capital Grant. We support this option. We understand it to be the least expensive for HUD, and feasible for Los Robles. The only additional request is to keep the current (not new) project-based Section 8 contracts in place.

Finally, the residents of Los Robles have formed a resident council, hired a consulting team, and selected a non-profit to act as our co-sponsor. Ecumenical Association for Housing. EAH manages over 1,000 apartments and has a strong track record of successful ownership.

Los Robles residents and Ecumenical Association for Housing will own and operate the project. Their involvement will enable the financing and rehabilitation plan to be put together promptly. Both Ecumenical Association for Housing and the residents will appoint board members to the board that will oversee the project. By being involved as owners, the residents will gain the responsibility and control of their homes and their community. Without a preservation program, such involvement would not be possible. Vouchers will not preserve affordable housing, nor empower residents to govern their homes and communities.

You have an excellent program that preserves our homes, increases our awareness and stabilizes families in economic hard times. Please, make it more efficient, but please, please, do not throw it out.

Again, thank you for the opportunity to be here today. It is truly an honor for me. I would also like to acknowledge Ms. Carol Owen, also a resident of Los Robles, who is very involved in preserving affordable housing. If you have any questions, I would be happy to answer them.

Thank you.

Statement of the National Council of State Housing Agencies
to the
Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Housing Opportunity and Community Development
on Preservation of Prepayment-Eligible Properties

October 17, 1995

Thank you for the opportunity to submit this statement on behalf of the National Council of State Housing Agencies (NCSHA) on low income housing preservation.

NCSHA is a national, nonprofit organization created in 1970 to assist its members in advancing the interests of lower income and underserved people through the financing, development, and preservation of affordable housing. NCSHA's members are Housing Finance Agencies (HFAs) with statewide authority. NCSHA's member agencies operate in every state and the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

State HFAs have issued more than $100 billion in Mortgage Revenue Bonds (MRBs) to finance more than 1.6 million lower income families' home purchases and more than $35 billion in multifamily bonds to finance more than 700,000 low income rental apartments. NCSHA's members also allocate the Low Income Housing Tax Credit (Tax Credit), which, since 1987, has helped finance more than 730,000 apartments for low income families.

Original Rationale For Preservation Program Still Valid

NCSHA strongly supported the enactment of the Emergency Low Income Housing Preservation Act (ELIHPA) and the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA) as a way to preserve desperately needed affordable housing and to avoid the human suffering and community upheaval that would have resulted when owners prepaid their HUD-insured mortgages and their properties converted to market rate use. For these same reasons, NCSHA supports a continued federal preservation effort today.

In enacting ELIHPA and LIHPRHA, the Congress recognized that program-eligible properties represent a valuable stock of affordable housing that would be impossible to replace and should be preserved. Most of these properties are decent, desirable places to live, and those that are not can be rehabilitated with relatively modest amounts of program funds. The properties have a mix of very low, low, and moderate income tenants that, if forced to leave, would have great difficulty finding alternative affordable housing in or near their communities.

Although estimates vary of how many project owners will choose to prepay in the absence of prepayment restrictions and incentives not to, it is clear that some will, and any amount of tenant dislocation and affordable housing loss is too much if there is a reasonable, cost effective way to avoid it.

Reform is Needed

Experience shows that ELIHPA and LIHPRHA, while successful in preventing prepayments and preserving properties for low income use, are flawed. These programs are very costly, especially in today's budget terms, and it is unlikely that Congress will appropriate the funds necessary for the project-based Section 8 assistance on which these programs rely. In addition, the programs are extremely complicated and cumbersome, requiring extensive analyses of project value, establishment of preservation rents, and rigid adherence to procedures.

Despite detailed appraisal requirements and rehabilitation needs assessments, repairs to these properties often have been minimal and insufficient to improve their condition to the quality necessary for long-term use. In addition, rents often must be set well above market rents to permit equity take-out loans to owners. Appraisal problems, though mitigated somewhat by the new appraisal system enacted in LIHPRHA, still slow preservation processing and may overvalue owners' equity and underestimate necessary repairs.

Program rules that increase rents for unsubsidized families sometimes cause them to relocate, increasing Section 8 costs for subsidized very low income tenants who take their place and changing the character of the properties to predominantly very low income dwellings. This destabilizes the communities where the projects are located and reduces the number of apartments available for moderate income families.

Another problem is the lack of priority given to projects most likely to prepay. While HUD's plan to prioritize the funding of approved plans of action by how soon a project will be eligible to prepay helps avoid prepayments, it will likely exhaust the limited resources without funding the projects that are actually most likely to prepay and in need of preservation. Resources should be focused on those properties most likely to prepay, and we would like to work with the Subcommittee over the coming weeks to discuss how such a system might work.

The Capital Grant Alternative

The answer to the problems with ELIHPA and LIHPRHA is not federal withdrawal from low income housing preservation. The federal government's investment in this vital resource is too great to pull out and lose much of it now. The appropriate response is to rewrite these programs to account for today's budget realities and respond to their deficiencies.

NCSHA and others have been considering how to improve the preservation program for some time. This discussion culminated recently in the Senate-passed FY 1996 HUD appropriations bill, which would establish a capital grant or loan mechanism to fund owner incentives in place of long-term Section 8 subsidies, value properties by capitalizing expected net operating income based on market rents, reduce the federal cost limit, restrict eligibility to fewer properties than are currently eligible, and allow owners to prepay their insured mortgages without restriction according to the provisions of their loan agreements.

We believe these reforms have several attractive features, such as reducing the long-term cost of preservation while preserving the housing at affordable rents for 50 years, eliminating the need for additional Section 8 subsidies, simplifying processing, and avoiding the rent increases that drive out low and moderate income tenants. The Congress must find a way to enact these or similar reforms this year, so they can be in effect as soon as possible and affordable housing can be saved.

However, it is also important that appropriations are provided to fund plans of action approved by HUD under current law. HUD indicates that more than 215 projects have approved "plans of action" costing more than $700 million. If not funded in FY 1996, their owners will be able prepay.

Despite our enthusiasm for preservation reform this year, NCSHA is concerned about some elements of the Senate reforms. Restricting eligibility for preservation incentives, lowering the federal cost limit, and establishing a unilateral right to prepay will each increase the number of prepayments. We urge legislation that would preserve a greater number of properties by establishing broader eligibility criteria, making the federal cost limit more flexible, and making the program mandatory.

We are also concerned that the bill's eligibility restriction that disqualifies projects that have not filed notices of intent may shut out properties that are likely to prepay and that should be preserved. Whether or not a project has filed a notice of intent is not a good indication of the government's interest in preserving that property. A more effective priority system should be developed.

Vouchers Are Not the Answer

Some critics of ELIHPA and LIHPRHA have suggested that they be repealed and that HUD give tenant-based rental assistance (vouchers) to residents of properties that prepay. We oppose this alternative because it does not avoid the displacement and disruption caused by prepayments, and is not an answer to the loss of affordable housing stock. Preservation incentives are significantly less expensive than producing new housing through acquisition, rehabilitation, or new construction.

Vouchers do not enable tenants to obtain housing in tight housing markets where affordable apartments are not available or where rents exceed what they can afford to pay even with a voucher. Vouchers also create a long-term government obligation that must be paid and renewed as long as the tenant remains eligible and wants the assistance. In addition, vouchers over the long term will be more costly than preservation incentives for most eligible properties.

The HFA Role

Opponents of ELIHPA and LIHPRHA say they must be repealed and no preservation program is possible because HUD does not have the capacity to administer it. We agree that HUD's capacity is limited. One solution to this problem is to direct HUD to allow other entities, such as HFAs, to assume some of the processing responsibilities.

HFAs offer HUD technical expertise and personnel to augment its capacity. HFAs have the capabilities and resources to commission and evaluate appraisals, determine costs and capital/rehabilitation needs of a development, evaluate mortgage credit, process mortgage loan proceeds, and certify costs. In addition, HFAs are able to underwrite and process loan applications based on internally or externally derived underwriting guidelines, evaluate operating budgets, ensure financial compliance, arrange for tenant services, and develop creative workout solutions where needed. With these resources, HFAs can process preservation applications in an expeditious and responsible manner, and generate substantial administrative costs savings to HUD.

HUD has the statutory authority now to delegate preservation processing, but has failed to implement it. The Massachusetts Housing Finance Agency (MHFA) worked diligently to persuade HUD to enter into a delegated processing arrangement to handle preservation program applications in Massachusetts, but HUD resisted, despite the notorious backlog and delays in processing applications in that area.

Many prepayment eligible properties in Massachusetts probably will prepay because their appraisal process has been delayed and they are therefore unlikely to be funded. This is another reason why we believe HUD should prioritize preservation funding awards -- to account for delays in processing among field offices and to preserve projects most likely to prepay, regardless of when plans of action are actually approved. In addition, owners are becoming increasingly frustrated with the program and will likely prepay unless they believe that the program is likely to be administered expeditiously and be funded adequately.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Housing Opportunity and Community Development, Committee on Banking, Housing, and Urban Affairs, United States Senate

Statement Submitted on October 17, 1995

MULTIFAMILY HOUSING

Issues and Options to Consider in Revising HUD's Low-Income Housing Preservation Program

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

GAO/T-RCED-96-29

Mr. Chairman and Members of the Subcommittee:

In conjunction with the Subcommittee's October 17, 1995, hearing on the Department of Housing and Urban Development's (HUD) program for preserving low-income housing, we are pleased to submit this statement for the record. The preservation program, created by legislation initially enacted in 1987 and revised in 1990, is aimed at maintaining the affordable low-income housing that was created primarily under two federal housing programs during the 1960s and 1970s. Under these programs, when owners received HUD-insured mortgages with 40-year repayment periods, they entered into agreements with HUD that imposed affordability restrictions, such as limits on the income levels of tenants and on the rents that could be charged at the properties. However, after 20 years, owners had the right to prepay (pay off) their mortgages in full without prior HUD approval and terminate the affordability restrictions. The preservation program has proven to be complex and costly, resulting in recommendations by HUD, HUD's Office of the Inspector General (OIG), and others to change or repeal the program.

Our statement is based primarily on work that we have carried out during the past several years on HUD's preservation program and on work that we have performed in preparation for this hearing. This statement focuses on (1) how the current preservation program works, (2) the status of preservation eligible projects, (3) concerns that have been raised about the program, and (4) options for revising the program.

In summary, we have found the following:

- To help maintain affordable housing, the current preservation program restricts owners' previously unlimited right to prepay mortgages but provides them with incentives to continue the affordability restrictions. HUD can approve a plan for prepayment only after finding, among other things, that the supply of comparable vacant housing is adequate in the relevant housing market. Those owners who agree to extend the affordability restrictions for the remaining useful life of their properties, may receive, subject to the availability of appropriated funds, various financial incentives, such as increases in federal rental assistance, financing of capital improvements, and federally insured equity take-out loans. Alternatively, the owners can sell their properties to purchasers who will maintain the affordability restrictions. The purchasers are eligible for incentives similar to those received by owners who extend restrictions.

- As of September 30, 1995, the owners of 1,122 projects eligible to participate in the preservation program had filed notices of intent to extend affordability restrictions or to sell the property to qualified purchasers. Of these, 736 projects had been approved for preservation; about 70 percent of these had completed the process. As of September 30, 1995, 223 were awaiting funding. If appropriations are not available to finance the preservation incentives, according to HUD, the owners of at least 127 of the 223 projects approved for preservation will have the right to prepay the mortgage and end the affordability restrictions in fiscal year 1996.

- While housing industry officials believe the preservation program is achieving the goal of preserving affordable housing, HUD, HUD's OIG, the House and Senate Committees on Appropriations, and the National Alliance of HUD Tenants have all expressed concerns about the program's high cost--over $1.2 billion or an average of $19,152 per unit for projects that have completed the preservation process. Specific concerns center on the size of incentives provided and the funding of incentives through increased federal rental assistance, thus creating an expensive, long-term commitment to government funding. HUD has also argued that the program is inconsistent with its efforts to reinvent the Department because, for example, the program promotes above-market rent structures and imposes "complex bureaucratic requirements" on private owners, residents, and state and local governments.

- Several options have been suggested for revising the current program to address these concerns. H.R. 2099, as approved by the Senate Committee on Appropriations in September 1995, proposes to replace the current program with an approach that restores owners' unlimited right to prepay mortgages and uses "capital grants/loans" in lieu of federal rental assistance payments to finance preservation incentives. Two alternative options that HUD has examined are (1) restoring owners' right to prepay and repealing the preservation incentives and (2) restoring owners' right to prepay and continuing preservation incentives, but on a more targeted basis and at a reduced level. Under each of these three options, low-income residents displaced as a result of owners' prepayment of the mortgage would be provided with some form of assistance. Some of the key questions to be assessed in comparing the merits of these options are: (1) Which option is the least costly method of providing housing assistance to those in need? (2) To what extent will eliminating or reducing the preservation incentives result in loss of valuable housing stock, create housing shortages, and cause displacement of residents? and (3) Can HUD effectively carry out whichever alternative is selected, considering its other responsibilities and capacity limitations?

Before discussing these issues in more detail, we would like to provide some background on the preservation program.

BACKGROUND

The owners of several thousand multifamily housing projects are, or over the next few years will be, eligible for federal financial incentives designed to compensate them for preserving their properties as affordable rental housing for low-income households. These properties were developed during the 1960s and 1970s with government assistance, mostly under the section 221(d)(3) mortgage insurance program authorized by the Housing Act of 1961 and the section 236 mortgage insurance program created by the Housing and Urban Development Act of 1968.[1]

In return for the federal assistance, the property owners agreed to rent units only to individuals and families meeting specific income limits. They also agreed to restrictions on the rents they could charge and the rates of return they could receive. Although mortgages under the programs were generally for a 40-year period, owners could elect to prepay the balance of their loans after 20 years. After prepaying the loan, an owner would no longer be subject to the affordability restrictions and would be free to charge market rate rents or convert the property to some other purpose, potentially displacing the low-income tenants.

As the 20-year anniversary of many of the mortgages approached, the Congress became concerned that the prepayment option could trigger a mass exodus from the program, the displacement of thousands of low-income families, and the permanent loss from the rental market of a significant quantity of affordable low-income housing. As a temporary measure to prevent these outcomes, the Congress enacted the Emergency Low-Income Housing Preservation Act of 1987 (also known as title II or ELIHPA),[2] which placed limitations on owners' prepayment rights but provided a number of incentives for owners to maintain their properties for low-income tenants. This was replaced by the current preservation program, authorized by the Low-Income Housing Preservation and Resident Homeownership Act of 1990, as amended (also known as title VI or LIHPRHA).

HOW THE PRESERVATION PROGRAM WORKS

The current program is designed to ensure that most units remain available and affordable to low-income families, while limiting but

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[1]Certain projects that are not FHA insured may also participate in the preservation program, including projects developed by state housing finance agencies for which mortgages can be prepaid. According to a HUD multifamily official, about 30 uninsured projects have been approved by HUD and another 33 have applications in process.

[2]Title II of the Housing and Community Development Act of 1987 (P.L. 100-242).

not precluding prepayment of the mortgage by the owner. It offers various financial incentives to those owners who agree to extend the current affordability restrictions for the remaining useful life of the property and to those who are willing to purchase the properties at a fair price and maintain the restrictions. The latter are called "qualified purchasers." Although the owners may elect to forgo the financial incentives and prepay, as a practical matter it is difficult to do so. Before allowing an owner to prepay, HUD must first determine that the action would not, among other things, (1) materially increase the economic hardship for current tenants, (2) cause these tenants to pay more than 30 percent of their income for rent, (3) cause involuntary displacement when comparable affordable housing is not available, and (4) materially affect the availability of affordable housing in the relevant housing market area. If the owner does prepay, however, the property is no longer subject to the affordability restrictions.

Owners seeking to extend the affordability restrictions, sell to a qualified purchaser, or prepay must file a notice of intent with HUD, the appropriate state or local jurisdiction, and the mortgagee, and must inform their tenants of the filing. Two independent appraisers, one selected by HUD and another by the owner, then appraise the property to establish its "preservation value." In general, the preservation value is based on the property's highest and best use.

The appraisal and the preservation value it establishes are key to the financial calculations made during the remainder of the preservation process and to the financial benefits that the owner ultimately receives. The preservation value represents the ceiling price for the sale of the property to a qualified purchaser. The preservation value, less the remaining debt on the property, also determines the "preservation equity," which is used in calculating some of the financial incentives for owners electing to extend affordability restrictions.

Once an owner files a notice of intent, HUD has 9 months to provide the owner with the appraisal results and certain other information the owner needs to proceed.[3] Within 6 months after receiving this information, the owner must file a "plan of action" with HUD for the desired option (i.e., either extension of the affordability restrictions and receipt of incentives; sale to a qualified purchaser who will maintain the restrictions; or prepayment and termination of the restrictions).

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[3]HUD has 9 months to respond to notices from owners who wish to extend affordability restrictions or sell to qualified purchasers and 6 months to respond to notices of intent to prepay the mortgages.

A plan of action for continuing the affordability restrictions must include, among other things, a description of the federal incentives the owner will need and an analysis of how the owner will address any financial or physical deficiencies connected with the property and maintain the low-income use restrictions. After approving the plan, HUD can enter into the agreements that are necessary to ensure that the owner (1) receives the authorized annual rate of return on investment (i.e., 8 percent of the preservation equity), (2) pays the debt service on the federally insured mortgage and any additional loan taken out to rehabilitate the property, (3) meets the projected operating expenses, and (4) establishes adequate cash reserves.

Subject to availability of funds, HUD is authorized to provide the owner with a number of incentives to ensure that these outcomes occur. Permissible incentives include (1) increases in federal Section 8 rental assistance,[4] (2) rent increases for current tenants, (3) financing of capital improvements under other HUD programs, and (4) access to project equity through an FHA-insured loan. Qualified purchasers are eligible for similar incentives. However, purchasers receive a larger percentage of the preservation equity (up to 95 percent compared with up to 70 percent for owners who extend the restrictions), and "priority purchasers" (i.e., resident councils, state and local agencies, or nonprofit organizations) are eligible for grants to help with the acquisition.

The owners who accept the incentives must enter into binding agreements with HUD to retain the affordability of the housing throughout the property's remaining useful life. They must also commit to adequately maintain and operate the property according to HUD's standards, not to displace the current tenants except for good cause, and to comply with certain rules governing future rent increases.

STATUS OF PROJECTS IN THE PROGRAM

As of the beginning of fiscal year 1996, 3,691 projects consisting of 472,854 housing units are or will be eligible to participate in the preservation program. Of this total, the owners of 1,122 projects consisting of 126,529 units had filed a notice of intent to extend the affordability restrictions or to sell the property to a qualified purchaser.

As of September 30, 1995, HUD had approved the owners' plans of action for 736 projects to continue preserving the properties for low-income use. Nearly 69 percent of these projects (506 projects

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[4]Section 8 rental assistance is provided by HUD's Housing Assistance Payments Program, authorized by the Housing and Community Development Act of 1974.

containing 63,201 units) had completed the process, received funding under the program, and agreed to extend the affordability restrictions for the projects' remaining useful life or to sell the property to a qualified purchaser.[5]

However, another 223 projects containing 26,521 units remained in the queue awaiting funding. HUD estimates that more than $644 million will be needed to fund the incentives for the remaining 223 projects. Under current law, owners with approved plans of action under LIHPRHA to sell may prepay their mortgages 6 months after the plan of action is approved or 60 days after the start of the subsequent fiscal year if federal funding for preservation incentives is unavailable. Owners with approved plans of action under LIHPRHA to extend the affordability restrictions may prepay their mortgages 15 months after the plan of action is approved. Of the 223 projects awaiting funding, HUD estimates that at least 127 could meet this criterion and be eligible to prepay their mortgages in fiscal year 1996 if funding for the program is not provided.

CONCERNS ABOUT THE PRESERVATION PROGRAM

While housing industry officials believe that the preservation program has generally been consistent with the legislation's goal of preserving affordable housing, various parties, including both HUD and HUD's OIG, have raised concerns about the program. HUD's multifamily housing officials believe that the primary problem with the existing program is that it creates a system under which property owners are effectively precluded from prepaying their mortgages and instead are given substantial incentives as compensation for continuing to preserve their properties as low-income housing.

While property owners are not specifically precluded from prepaying their mortgages and terminating the affordablility restrictions, the current program establishes limitations that significantly restrict their ability to prepay. Specifically, the low-income restrictions can be terminated through prepayment only if HUD finds that the effects on existing tenants and the low-income housing market would be minimal. As of October 1, 1995, HUD staff told us that only five projects had been approved for prepayment. Some owners have sued the government for, among other things, breach of contract because the preservation laws placed restrictions on mortgage prepayments that would have otherwise been unrestricted after 20 years. On March 27, 1995, the United States Court of Federal Claims ruled in favor of owners who brought suit on this

[5]According to a HUD multifamily official, there are 7 projects that have been approved and for which funding is available that have not yet completed processing.

issue and sent the case back to trial to determine damages with respect to the breach of contract claim.[6]

While the program limits owners' ability to prepay their mortgages, it provides substantial incentives to owners or purchasers to preserve the properties as affordable housing. Since the program was enacted, it has cost over $1.2 billion to preserve 63,201 units in the 506 projects that have completed the process.[7] This amount represents an average cost of $19,152 per unit to preserve the properties.

HUD, HUD's OIG, the House and Senate Committees on Appropriations, and the National Alliance of HUD Tenants have all expressed concerns about the cost of the preservation program. Among the factors cited as contributing to the high cost of the program are the following:

- The incentives provided to owners and purchasers are based on a substantial portion of a project's preservation equity--up to 70 percent of equity for owners who agree to extend low-income affordability restrictions and 95 percent of equity for purchasers of properties who agree to preserve the affordable housing. The National Alliance of HUD Tenants has argued that these incentives are excessive since, in its view, (1) taxpayers created most of the equity in the properties through housing subsidies and insurance funded at taxpayers' expense and (2) property owners had typically made large profits when the properties were constructed.

- Compensation provided to owners for preserving their projects is typically funded through increased rents, part of which are paid by HUD through increased Section 8 rental assistance. According to HUD's multifamily officials, using Section 8 subsidies to fund incentives and requiring owners to preserve their property for its remaining useful life has created an expensive, long-term commitment to government funding. In addition, as HUD's OIG has noted, HUD expends significant staff time and costs in processing and monitoring the preservation program, as well as in overseeing federal rental assistance contracts under Section 8 and FHA-insured loans.

- Incentives are provided to some projects whose owners are, for various reasons, unlikely to prepay their mortgages. This

[6]Cienega Gardens v. the United States, 33 Fed. Cl. 196, United States Court of Federal Claims.

[7]According to HUD's OIG's July 14, 1995, report, HUD's Multifamily Preservation Program, the program's costs include Section 8 funding for the initial 5-year contract period, but not for the remaining terms of the mortgage.

concern is compounded by the fact that no minimum amount of preservation equity is needed to participate in the program.

- The program has, in some cases, caused HUD to pay excessive amounts toward repair of properties that have been approved for preservation.

The housing industry officials that we contacted acknowledged that there were concerns about the cost of the program but believed that the program has basically been consistent with the legislation's goal of preserving low-income properties.

In addition to expressing concern about the cost of the program, HUD has also expressed the view that for several reasons the preservation program is inconsistent with efforts to reinvent the Department. First, the program continues to link long-term, project-based assistance with HUD mortgage insurance which can result in losses to HUD from loan defaults unless the project-based assistance is continued. HUD believes this linkage is a fundamental cause of the problems that currently affect the health of a substantial portion of HUD's multifamily loan portfolio. Second, the program promotes artificial, above-market rent structures as opposed to market-driven rents. Third, the program imposes "complex bureaucratic requirements" on private owners, residents, and state and local governments.

HUD's OIG has also expressed concern that under the program, the tenants in projects that have been preserved are no longer mixed-income but rather are predominantly subsidized under Section 8--a situation that runs counter to HUD's philosophy that mixed-income neighborhoods create healthier and more stable environments. Along these lines, the OIG's July 14, 1995, report on the preservation program found--based on an analysis of 296 projects approved as of December 31, 1994--that the percentage of units receiving Section 8 assistance had increased from 32 percent to 76 percent for title II projects and from 45 percent to 87 percent for title VI projects. Housing industry officials we contacted agreed that the program has increased the number of housing units receiving Section 8 assistance, but believed that the program had not caused any widespread change in tenant income profiles.

OPTIONS FOR REVISING THE PRESERVATION PROGRAM

Various parties have suggested revising the program to address the concerns discussed above. Under one option, the current program would be replaced with an approach that restores the owners' unlimited right to prepay mortgages and uses capital grants and loans in lieu of Section 8 subsidies to finance the preservation incentives. Such an approach is included in H.R. 2099, as approved by the Senate Committee on Appropriations on September 13, 1995. Two alternative options that HUD has examined are (1) restoring the owners' right to prepay and repealing preservation incentives and

(2) restoring the owners' right to prepay and continuing preservation incentives, but on a more targeted basis and at a reduced level. Under all three options, low-income residents displaced as a result of prepayment would be provided some form of assistance.

Capital grants/loans

The capital grants/loans proposal, as specified in H.R. 2099, would restore the owners' unlimited right to prepay their mortgages, while providing owners (or purchasers) with a different set of financial incentives if they choose instead to continue affordability restrictions. The principal change in incentives would be the addition of two new forms of incentives--capital loans and grants, which would provide the owners with access to a portion of the preservation equity and also directly cover the costs of necessary rehabilitation. The incentives involving (1) increased Section 8 rental assistance, (2) equity loans insured by HUD, and (3) second mortgages for capital improvements would be eliminated.

The capital loans would be provided to owners who agree to extend affordability restrictions. As with the current equity loans, these loans could be for amounts up to 70 percent of the preservation equity. However, no interest would be charged and repayment would not start until the original mortgage was paid in full. The owners of such projects would also be allowed an annual return of 8 percent on the remaining 30 percent of equity in the project. According to housing industry officials, this return would be included in the project's operating budget, which is used as a basis for determining the project's rents.[8]

If the owners elect to sell their property to a qualified purchaser, the purchaser would be eligible for a capital grant in an amount up to 100 percent of the preservation equity, or at their option, a capital loan for the same amount. (Currently, purchasers can get equity loans for up to 95 percent of preservation equity.) Unlike the capital loans to owners who extend the affordability restrictions, the loans to purchasers would carry interest at no less than the going federal rate. Repayment, however, would be deferred until the property was resold or refinanced, whichever comes first (or until such later date as may be required to maintain the affordability restrictions for the property's remaining useful life). HUD would be permitted to provide the capital loans in five annual installments, but, if it does so, would have to pay the owner interest on the unpaid amount. Qualified purchasers are also entitled to an 8-percent return on

[8]Officials stated that rent increases resulting from the inclusion of this return on equity would be offset to some degree by the fact that some return on owner equity is already included in project budgets.

the actual cash they invest in the projects from sources other than the federal preservation assistance.

The capital grants/loans proposal also would establish minimum equity amounts that an owner or purchaser would need to qualify for the incentives. To qualify for incentives, owners would need a preservation equity at least equal to the lesser of three amounts: $500,000 per property, $5,000 per unit, or eight times the appropriate HUD fair market rent for all the eligible units.

The proposal would also to some degree change the protection for displaced tenants. HUD would no longer guarantee Section 8 rental assistance to low-income tenants (i.e., those earning between 50 and 80 percent of the area's median income) but would continue the guarantee for very-low-income tenants (i.e., those earning less than 50 percent of the area's median income). HUD could, however, provide Section 8 assistance to the low-income group if appropriations were available. In lieu of a current requirement that owners pay half of the displaced tenants' relocation expenses, the capital loans/grants proposal would require HUD to pay relocation expenses, up to $1,500 per family, for low-income displaced tenants who are paying more than 30 percent of their adjusted income for rent and utilities.

This proposal would eliminate requirements in the current law that, in general, restrict increases in tenants' rent contributions to levels that do not exceed 30 percent of tenants' adjusted income and require that rent increases above certain levels be phased in. It would also revise the existing law's requirement that to the extent practicable new tenants in preservation projects be at the same proportion of very-low, low, and moderate incomes as the tenants who resided in the project when the project's plan of action was approved or on January 1, 1987, (whichever results in the greater proportion of very-low-income families). Instead, maintaining the same income mix among tenants as on the date of the plan of action would only be required to the extent that federal assistance is available. Housing industry officials believe that these changes in the program are needed to ensure the project's viability since Section 8 assistance would no longer be used to fund preservation incentives.

The proposal also makes a variety of other changes in the existing program including (1) revising the maximum federal cost limits for the program, (2) revising the definition of priority purchasers to facilitate the use of low-income housing tax credits in connection with the program, and (3) eliminating the requirement that excess income received under the Section 236 program be remitted to HUD.

According to housing industry officials that we contacted, the capital grants/loans program keeps those aspects of the current preservation program that are working and adjusts various other features to address concerns about the existing program. These officials believe that the capital grants/loans proposal would improve the current preservation program in a number of respects. These include the following: first, owners' unrestricted right to prepay which was taken away under the current program would be restored. Second, costs would be lower than they are under the current program. Third, properties could be preserved without additional Section 8 assistance, thus addressing the concern about linking preservation incentives with Section 8 assistance. Finally, a minimum level of preservation equity would be established, thus addressing concerns that the current program provides preservation incentives to property owners that are unlikely to prepay in any case.

On the basis of our discussions with HUD and housing industry officials and our review of reports by HUD's OIG and other documents, there are also a number of concerns regarding the capital grants/loans proposal. These include the following: (1) the incentives provided to owners and purchasers under the capital grants proposal may actually be higher than those in the current program; (2) because owners would receive most of their equity up front, their commitment to maintaining quality housing over the life of the property is questionable, potentially necessitating additional federal assistance in the future; (3) projects preserved as affordable housing will remain in HUD's inventory of insured properties, requiring continued HUD monitoring and exposing the government to future costs in the event of loan default; (4) the level of protection for tenants in projects whose owners prepay is less than it is under the existing program; (5) even if a minimum threshold of preservation equity is established for participants, owners who are unlikely to prepay may continue to receive preservation incentives; (6) because the appraisal process and estimates of repair costs are subjective, guarding against overestimated preservation values will still be difficult; (7) changes in the affordability requirements could reduce some of the public policy benefits of the current preservation program; (8) elimination of the requirement that excess Section 236 income be returned to HUD could lessen HUD's ability to use such funds to assist needier projects; and (9) depending upon how the capital grants/loans proposal is handled, there could be a variety of tax implications for owners, and if applicable, purchasers. Furthermore, as discussed in the next section, there are concerns as to whether the capital grants proposal is less costly than other options for revising the preservation program.

<u>Eliminate Preservation Incentives and Provide Tenant-Based Assistance</u>

Under an alternative option that HUD has considered, the owners' prepayment right would be restored but preservation incentives would be eliminated. Owners would be allowed to prepay their mortgages after 20 years, or they could continue to operate under the terms of their current mortgage. However, they would not receive incentives for forgoing their right to prepay.

If the owners prepay, certain displaced tenants would be provided with housing assistance. HUD has examined various options for providing such assistance. For example, in addition to assisting persons already receiving Section 8 assistance, options include (1) providing tenant-based assistance to unassisted very-low-income tenants, (2) providing tenant-based assistance to low- and very-low income tenants not currently receiving assistance, or (3) providing tenant-based assistance to very-low-income tenants and covering a portion of low-income tenants' relocation costs.

HUD's multifamily officials believe that a "prepayment/tenant protection" approach that focuses on allowing owners to prepay while protecting tenants is consistent with the Department's proposals to reinvent itself and restructure the multifamily portfolio. These proposals include moving from project-based housing assistance linked to properties to tenant-based assistance, which the tenants take with them wherever they live. Two advantages of tenant-based assistance cited by HUD are that such assistance (1) can provide tenants with greater housing choice, whereas with project-based assistance tenants lose their assistance if they move from the assisted property, and (2) breaks the interdependence between housing assistance and federal payments for defaults on FHA-insured loans which HUD's management believes has undermined the Department's ability to effectively manage the multifamily portfolio. Allowing owners to prepay would also be consistent with the view that rents in projects are better set by the marketplace than through HUD's regulation. In this regard, HUD's OIG has stated that returning projects eligible for preservation to the discipline of the private sector will result in projects that are better maintained and less costly to the federal government.

In addition, this option could help the Department overcome the lack of capacity to adequately manage the multifamily portfolio that it has been trying to address for a number of years.[9] To the extent that restoring the owners' prepayment right results in loans leaving FHA's insured loan portfolio, oversight responsibilities and potential federal liability for defaults of those loans would be eliminated.

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[9]HUD has been unable to provide adequate oversight and management of its existing multifamily loan inventory. See HUD Management: FHA's Multifamily Loan Loss Reserves and Default Prevention Efforts (GAO/RCED/AIMD-95-100, June 5, 1995) and HUD Management: Greater Oversight Needed of FHA's Nursing Home Insurance Program (GAO/RCED-95-214, Aug. 25, 1995).

A primary risk of or uncertainty about the prepayment/tenant protection option centers on its impact on low-income tenants. For example, HUD's OIG has reported that tenants believe that tenant-based assistance will not prevent displacement of all the affected families. There are also concerns that all the displaced low-income residents may not be able to find alternate housing using tenant-based assistance because (1) in some tight housing markets, an adequate supply of alternate housing is not available and (2) some property owners may not accept tenants with such assistance. As a result, some displaced tenants may have to move out of some communities to other areas to seek affordable housing. To help mitigate such concerns, HUD is examining an option under which elderly, disabled, and possibly family tenants living in properties whose owners prepay, would be eligible to receive tenant-based assistance at levels exceeding the normal maximum limits for such assistance if the new rent for their unit exceeds such limits. This approach is aimed at allowing such residents to continue to remain in their units.

There are also concerns that eliminating preservation incentives will result in the permanent loss of good-quality housing stock for low- and moderate-income tenants. After prepayment, these properties may be converted to other uses, such as condominiums, or upgraded to serve middle- and upper-income families. However, several housing industry officials told us that, if projects are again allowed to prepay their mortgages, owners' access to conventional refinancing could be contingent on a number of factors surrounding the project, such as location and condition. Such contingencies, depending on the degree they affect the projects' value and the associated risk, could limit the number of projects that could qualify for this type of financing.

Yet another issue is whether this option is more or less costly than the capital grants/loans option. A recent analysis prepared by HUD staff compared the costs of the capital grants proposal to the costs of an alternative under which preservation incentives would no longer be funded, owners would be allowed to prepay, and tenants would be protected by receiving Section 8 assistance. The analysis indicated that the prepayment/protection option would be cheaper for the first 15 years but that capital grants would subsequently be less costly.[10] HUD staff also noted, however, that

[10]HUD's analysis compares the costs under the two options for projects in its preservation pipeline, which includes about 150,000 units. HUD assumes that 75 percent of the owners would prepay if preservation funding were discontinued and 20 percent of owners would prepay if capital grants/loans were available. HUD assumed that for projects whose owners prepay, Section 8 assistance would be provided to those households that already receive Section 8 assistance as well as to very-low-income and low-income households that are not currently receiving such assistance. HUD also assumed

the two options are not directly comparable in that the level of assistance provided to tenants differs under the two options--that is, considerably more tenants receive Section 8 assistance under the prepayment/protection option than under the capital grants/loans option. Section 8 assistance limits tenants' contribution to rent to 30 percent of the household's income, while unassisted tenants may be required to pay more than 30 percent of their income for rent under the capital grants/loans proposal. Industry representatives told us that they had not seen HUD's analysis but believe that the capital grants/loans option would be less costly than the prepayment/protection option after a much shorter period of time. We have not performed a detailed assessment of HUD's analysis.

A More Targeted Preservation Program

HUD's multifamily housing officials told us that another option that HUD is currently considering is establishing a more-targeted, scaled-down preservation program. As in the other two options, the owners' unlimited right to prepay their mortgages would be restored. While some incentives would be authorized for owners or purchasers who wished to extend the affordability restrictions, the incentives would be reduced and/or more targeted than under the current program or the capital grants/loans proposal.

While the specific provisions of such a proposal are still being formulated, HUD officials said that the following approaches are being considered: (1) restoring owners unrestricted right to prepay their mortgages, (2) using capital grants or loans in place of existing preservation incentives but, perhaps, at lower levels than those in the existing program and under the capital grants/loans proposal, (3) targeting the program to emphasize selling the properties to entities controlled by tenants and to public agencies, and focusing on the projects whose owners are highly likely to prepay and where local involvement and support are high, and (4) limiting the amount of repair costs that HUD is responsible for covering.

Under this option, tenants in projects whose owners prepay would receive tenant-based assistance. The approaches for providing such assistance are the same as those described for the second option.

Because this option is not fully formulated, it is difficult to assess its benefits and costs. However, HUD's multifamily officials believe that a highly targeted preservation program is likely to be less costly than the capital grants/loans option and would allow HUD to promote the preservation of selected properties

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that under the prepayment/protection option, about 20 percent of households would be provided with assistance at levels that exceed the normal limits for such assistance.

through sales of those projects. Potential concerns about this option relate to (1) how HUD would target projects for preservation and (2) whether the projects could be preserved at reduced preservation incentive levels. In addition, to the extent that the proposal would result in a significant number of prepayments, many of the same concerns that exist regarding the prepayment/tenant protection option would apply.

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This concludes our statement. We hope that the information we have provided will assist you and the other members of the Subcommittee in your deliberations.

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