



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

MEMORANDUM FOR THE DIRECTOR

FROM: Bob Litan

SUBJECT: Background for Meeting with Sen. Mikulski

Attached are briefing materials for tomorrow's meeting on HUD's appropriation and the Mark to Market proposal. Included under tabs are:

- A. A Comparison of the House Appropriations mark for the VA/HUD bill with the President's Budget
- B. Summary points on the Mark to Market proposal.
- C. Details on Mark to Market
- D. A graph describing the relationship between rental subsidies and market rents
- E. A HUD document describing Mark to Market

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HOUSE APPROPRIATIONS SUBCOMMITTEE
ON VA, HUD AND INDEPENDENT AGENCIES

Preliminary Analysis

and

Comparison to the President's Budget Plan

July 17, 1995

(Updated)

**VA, HUD, INDEPENDENT AGENCIES APPROPRIATIONS:
PRESIDENT'S FY 1996 REQUEST VS. REPUBLICAN FY 1996 EXPECTED
ACTION**

Cuts programs under its jurisdiction by about \$9 billion below the President's request for 1996 – 28 percent of the \$32 billion that Congress plans to cut in non-defense discretionary spending.		
	PRESIDENT'S 10-YEAR BUDGET	REPUBLICAN CUTS
National Service	Provides \$819 million in 1996 for AmeriCorps, Learn and Serve and related national service.	Eliminates AmeriCorps, Learn and Serve, and related programs.
AmeriCorps	Increases to \$430 million in 1996, giving another 21,000 young Americans the opportunity to serve their communities and earn an education award.	Eliminates AmeriCorps. Nearly 50,000 young middle-income Americans will lose the opportunity to serve their communities.
Learn and Serve	Increases to \$60 million in FY 1996, creating 140,000 new opportunities for children, adolescents, and college students to help their communities while developing a service ethic.	Eliminates Learn and Serve. 580,000 children, adolescents, and college students will be unable to participate in Learn and Serve.
HUD Budget	Provides \$24.3 billion and restructures HUD to devolve responsibilities to States and localities within a framework of national goals.	Provides \$19.1 billion (\$5.2 billion below the President's request and \$6.4 billion below 1995).
HUD Homeless Assistance	Includes \$1.12 billion in 1996 for a new homeless assistance fund to help communities develop continuum-of-care systems to reduce homelessness.	Cuts 1996 HUD homeless funding almost in half, to \$576 million, reducing ability to serve the 600,000 persons homeless on any given night.
HUD Vouchers (Certificates)	Provides funding for 50,000 additional certificates in FY 1996 and 530,000 over seven years.	No additional certificates, ending 20 year bipartisan precedent. 680,000 fewer families provided housing subsidies over 7 years.
HUD Public Housing	Provides \$8.1 billion in 1996 for public housing capital and operating funds, enough to reduce a backlog of capital needs and tear down or reconfigure the worst projects.	Cuts 1996 funding by 37 percent, or \$3 billion, and repeals the requirement that rents be set at 30 percent of a household's income.
HUD Public and Assisted Housing Rents	Retains requirement that rents be set at 30 percent of a household's income. Gives PHAs flexibility to encourage work and retain role models in housing projects without punitive rent increases for poorest families.	Repeals current rent limitation. Minimum rent of \$50 plus utilities for all public and assisted housing. Increases rents of 600,000 families by average \$400 to \$600 per year. Rent for Section 8 certificates and vouchers increases to 32% of income – an increase of \$140 per year for average tenant.

HUD FHA Multifamily Insurance: Insures repayment of loans for construction of multifamily housing.	Continues program, requesting appropriation required by credit reform to reflect potential loss to FHA fund.	Suspends program for one year, will shrink supply of affordable housing for low-and moderate income families and elderly by 100,000 units.
Community Development Financial Institutions (CDFI) Fund	Provides \$144 million in 1996 to community development banks, which would leverage an estimated \$600 million in the country's most distressed communities.	Eliminates the CDFI Fund.
EPA Budget	Continues Administration's strong support for EPA by providing \$.1 billion over 1995.	Cuts EPA's budget by 33 percent reduction below fiscal 1995.
Superfund Clean-ups of Toxic Wastes	Increases Superfund cleanups of toxic waste dumps by \$130 million.	Cuts spending by 30 percent below 1995; bars cleanup of any more sites.
NASA Budget	Restructures NASA using a balanced Space Station and science program that does not close any research centers.	Provides \$13.5 billion (\$0.7 billion below the President's request and \$0.6 billion below 1995).

OVERVIEW

The Subcommittee mark would cut programs under its jurisdiction by about \$9 billion below the President's request for 1996 -- 28 percent of the \$32 billion that Congress plans to cut in non-defense discretionary spending.

The Subcommittee mark attacks the President's priorities on several fronts:

- It virtually eliminates funding for the President's investment programs over which it has jurisdiction:

- It eliminates national service programs.

- It eliminates Community Development Financial Institutions.

- It slashes the Environmental Protection Agency (EPA) by a third.

- It cuts funding for HUD homeless programs ^{by 40%} ~~in half~~.

- The Subcommittee also includes legislative provisions that have not been debated through the necessary authorization and hearing process and have no place in appropriations bills:

- It limits EPA's implementation of the Clean Air and Clean Water Acts.

- It restructures NASA.

- It imposes substantial rent increases on tenants in public and private HUD-assisted housing.

NATIONAL SERVICE

Subcommittee:

- Eliminates AmeriCorps, Learn and Serve, and related programs.

-- [In a related matter, the Labor-HHS Subcommittee mark also cuts the other piece of national service: It cuts VISTA programs by almost 60 percent and the senior volunteer programs by about one-third].

- The VA/HUD cuts will mean:

-- Nearly 50,000 young, middle-income Americans will lose the chance to serve their communities through AmeriCorps in locally-identified areas of crucial need and earn an educational award to help pay for college or other training.

-- Another 580,000 children, adolescents, and college students will be unable to participate in Learn and Serve, helping communities solve problems while also developing the ethic of service.

President:

- Provides \$819 million in 1996 for AmeriCorps, Learn and Serve and related national service opportunities.

-- For AmeriCorps, 1996 funding would provide another 21,000 young Americans with the chance to help meet locally-determined needs and earn an educational award.

-- For Learn and Serve, 1996 funding would provide 140,000 additional service opportunities to help children, adolescents, and college students develop the service ethic while contributing to their communities.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT:

The Subcommittee allocation for HUD is \$19.1 billion (\$5.2 billion below the President's request and \$6.4 billion below 1995).

Homeless Assistance.

Subcommittee:

- 
- Cuts 1996 HUD homeless funding ~~almost in half~~ ^{by 70%}, to \$~~5~~⁶76 million, and
 - Cuts FEMA Emergency Food and Shelter Assistance, which supports local homeless programs, by \$30 million, to \$100 million.

These cuts will:

- Combined with large cuts in low-income housing subsidies (below), will increase the numbers of homeless,
- Deny communities help needed to create transitional and longer-term housing options for the homeless, and
- Reduce emergency services.

President:

- Would provide \$1.12 billion in 1996 for a new, homeless assistance fund to help communities develop continuum-of-care systems to reduce homelessness.
- The President and HUD have made cutting the number of homeless, who number 600,000 on any given night, a major priority.

Vouchers.

Subcommittee:

- Provides no funding for incremental housing vouchers other than to renew outstanding ones, and
- Provides 50,000 fewer vouchers in 1996 than the President's request.

President:

- Adds over 500,000 voucher subsidies over 7 years.

Public housing.

Subcommittee:

- Would cut 1996 funding by 37 percent, or \$3 billion, to repair, rehabilitate, and modernize housing projects and provide annual subsidies to operate and maintain 1.4 million units for the low-income and elderly.

- These cuts will force Public Housing Authorities to under-maintain and abandon projects or cut security and services.

- Would repeal the requirement that rents be set at 30 percent of a household's income.

- Many PHAs would raise rents on poorest families, forcing some into homelessness and others to use most of their cash income for rent.

President:

- Would provide \$8.1 billion in 1996 public housing capital and operating funds, enough to:

- Reduce a backlog of capital needs,

- Tear down or reconfigure the worst projects, and

- Prepare for a proposed transition to portable assistance, giving choices to public housing residents.

Public and assisted housing tenants.

Subcommittee:

- Requires public housing and Section 8 residents to pay minimum rent of \$50 plus utilities.

- If enacted immediately, this would increase rents paid by 600,000 public housing and Section 8 families by average of over \$460 per year.

- Increases rents paid by residents who get Section 8 vouchers from 30 to 32 percent of adjusted income.

- This would take away \$140 per year from the average assisted family.

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How is this cons?

does this work

w/ MTM?



- Suspends caps on tenant rent in public housing.

President:

- Includes rent reforms to encourage public and assisted housing recipients to move towards self-sufficiency, but
- Would not arbitrarily impose higher rent burden on low-income tenants.

FHA multifamily mortgage insurance programs.

Subcommittee:

- Would eliminate all credit subsidies for multifamily mortgage insurance:
 - Denying support, each year, for over 56,000 low and moderate income rental units, and
 - Exacerbating shortage of affordable housing.
 - In New York State, insurance would not be available for 8,400 housing units.
 - In southern California, insurance would not be available for 4,100 housing units.

President:

- Provides \$188 million in credit subsidies in 1996 to help finance multifamily housing.

Community Development Financial Institutions (CDFI) Fund

Subcommittee:

- Would eliminate the CDFI Fund.

President

- Would provide \$144 million in 1996 for the CDFI Fund.
- Funding in 1996 would leverage an estimated \$600 million in investments, loans, and financial services in the country's most distressed communities.

ENVIRONMENTAL PROTECTION AGENCY:

The Subcommittee allocation for EPA is \$4.9 billion (\$2.5 billion below the President's request and \$2.4 billion below 1995).

EPA budget.

Subcommittee:

- Cuts EPA's budget by 33 percent below 1995, jeopardizing public health by quashing enforcement of pollution control rules and blocking new protections.

President:

- Continues Administration's strong support for EPA by providing a net \$.1 billion increase over 1995.

Operating Program.

Subcommittee:

- Cuts EPA's pollution control and enforcement programs by \$450 million.

-- The over 50 percent cut in enforcement would decimate EPA's ability to enforce environmental laws.

-- The cuts could necessitate layoffs of several thousand workers.

President:

- Proposes 14 percent increase for EPA's operating programs, the backbone of the nation's efforts to protect the environment.

Drinking Water State Revolving Funds.

Subcommittee:

- Provides no funds in 1996 and eliminates \$225 million in prior-year funding not included in H.R. 1944's \$1.1 billion rescission:

-- This \$225 million was restored to H.R. 1944 in response to the President's veto.

President:

- Proposes \$500 million to establish new state revolving funds to help municipalities provide clean, safe drinking water.

-- That will help prevent problems such as the cryptosporidium outbreak in Milwaukee that killed 100 people and caused illness in another 400,000.

-- It will most affect the 30 million people served by a system that violated a drinking water standard in the past year.

Superfund Clean-ups of Toxic Wastes.

Subcommittee:

- Would cut spending by 30 percent below 1995 and prohibit cleanups of additional sites.

-- This would eliminate planned funding for 70 long-term site cleanups and 200 cleanups to address immediate public health threats, subjecting hundreds of thousands of citizens to continued exposure to dangerous chemicals.

- Proposes that taxpayers pay for all cleanups, not polluters who created the dumps.

President:

- Proposes a \$130 million increase for Superfund cleanups of toxic waste dumps.

Overriding Environmental Laws.

Subcommittee:

- Includes legislative "riders" to overturn existing law without any hearings on their environmental impact.

-- They block or rescind numerous rules to protect public health, including those to ensure safe water, food, and air.

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION:

The Subcommittee allocation for NASA is \$13.5 billion (\$0.7 billion below the President's request and \$0.6 billion below 1995).

Science and Technology Programs.

Subcommittee:

- Significantly cuts NASA's S&T programs.
 - Cancels \$2 billion unmanned Cassini mission to Saturn and replacement airborne infrared telescope.
 - Cassini cut will have a major impact on Jet Propulsion Lab and Cal Tech in California, and could cost 4,000 jobs across the nation.
 - Significantly cuts NASA's contribution to several Administration technology initiatives, including High Performance Computing and Communications, Clean Car, and research improvements in air traffic control.
 - Proposes to close three NASA research centers by 1988 in Maryland, Alabama, and Virginia, affecting 10,000 civil service jobs and 13,000 contractor jobs.

President:

- Provides \$14.3 billion in 1996 and restructures NASA using a balanced Space Station and science program that does not close any research centers.

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Details on HUD's Mark To Market Proposal

MTM Overview

The Mark to Market proposal ("MTM") is designed to address systemic problems in the portfolio of 9,000 rental properties (about 900,000 units) that receive both mortgage insurance from FHA and rent (Section 8) subsidies to lower-income tenants that is tied specifically to that property -- it is not portable. MTM will transition this portfolio to the marketplace by restructuring mortgages (paying insurance claims equal to mortgage writedowns to reflect the true economic worth of properties) and giving assisted tenants vouchers. In most cases, the voucher will allow them either to move or to continue renting where they are.

Stakeholders may disagree on the solution, but there must be agreement on the budget problem: There isn't enough money on the discretionary side to renew all expiring Section 8 contracts at the old subsidy level.

House Appropriators Force the Action

The House VA/HUD appropriations bill renews expiring project-based subsidies as portable vouchers. No funds are provided for "property disposition" rent subsidies to be attached to properties sold by FHA after being acquired through default. Nor are funds provided for additional "loan management" project-based subsidies to bail out failing insured projects. All of these actions are consistent with our 1996 budget proposal for MTM.

However, the appropriators' solution is incomplete as a policy: taken alone it would create enormous problems for everyone -- HUD, owners, in some cases tenants. *To avoid a chaotic and costly unwinding, there must be a policy that creates an orderly way to handle the restructuring of this portfolio. The other "half" of the policy is in our MTM proposal,* and will require action by the authorizers.

The Logic of MTM in More Detail

1. Very broadly, given the limits on discretionary spending, we could have chosen one of two paths:
 - a. Keep subsidies project-based but give HUD authority to administratively bring rents down to FMRs, i.e., set the subsidy levels bureaucratically on a project-by-project basis.
 - b. Use vouchers to protect the tenants but let the market set rents, i.e., subsidize tenants, not projects (letting market determine the rents for each unit).

We chose path b.

2. Note for starters -- either solution, in some sense, marks to market, so MTM by itself shouldn't be the issue: the issue instead should be whether to continue to use the old project-based system of subsidies, which we can no longer afford, or begin to empower people, while at the same time generating long-term savings. ✓

- a. Supporters of continuing a project-based system argue that letting the market do it will lead to too much disruption; in particular, that giving people freedom to move will "tip" some (many) projects over the brink (as higher vacancy rates lead to a vicious cycle downward)
- In fact, however, by simply renewing the Section 8 contracts that are now expiring, we leave in place incentives for other landlords -- with their Section 8 contracts expiring in the near future -- to milk their properties (since given overall government funding constraints, there still will be uncertainty about whether those contracts will be renewed)
 - And second, we set a bad precedent. Whatever decisions are made now on whether to renew expiring contracts will have critical precedential effects: if the current expirations are rolled over, it will be hard to deny similar treatment to future expirations. Therefore, it is essential that we get this right at the start.
- b. The basic issue comes down to this: markets have proven to outperform bureaucracies in almost all other spheres of economic activity; there is no reason to believe that housing is the exception.
- When properties are exposed to the market, their owners will have incentives to maintain them.
 - When tenants are given market power to choose the units best for them, landlords will compete to serve them.
 - Market incentives will thus reduce the Government's costs while increasing the benefits per subsidy dollar.

3. The administrative design of MTM is realistic and effective.

- The approach will be proactive. It will use private partners -- possessing more flexibility than is possible in a government agency -- to aggressively restructure the portfolio. These partners will have a financial stake in restructuring that coincides with the Federal government's interests. HUD is fleshing out this concept and they welcome the involvement of owners in this process.

Budget Scoring Issues

- MTM presents some novel budget scoring issues, partly because it encompasses both discretionary and mandatory changes. HUD has performed a detailed financial analysis indicating that MTM is less costly than maintaining the status quo. This analysis probably understates the cost savings because it does not estimate the indirect savings from revitalizing the physical stock and giving assisted tenants choice.
- The House appropriators' action would increase mandatory default costs for the FHA insurance fund because weak properties will no longer be propped up; but these are "indirect effects" that CBO will not score against the appropriators.
- Subsequent enactment of MTM will reduce default costs by providing FHA with new authorities to manage the portfolio's transition. The Administration has scored MTM as neutral from a PAYGO/credit reform standpoint. The Budget Resolution does not include MTM but does include general language suggesting that authorizers would get sympathetic treatment of such a policy in reconciliation.
- Our goal, and we believe that of our counterparts on the Hill, is to make sure that arbitrary scoring conventions don't get in the way of good policy.

Some Questions and Answers about MTM

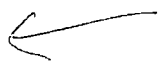
Does the current system work? No.

- Newer (Section 8 New Construction) properties: Many (not all) provide good service; but they cost far too much -- 61 percent have rents that are 120 percent or more above the FMR.
- Older properties: This is a more complicated and varied story. Again, many projects provide decent housing at modest subsidy costs. But, despite the layering on of additional subsidies to prevent defaults and recapitalize properties, the condition of this stock has been weakening while the cost to the Government has been rising. Twenty percent of the units are in a very deteriorated condition. ✓
- There is a growing perception that Section 8 rental assistance does not work, that it is too costly and that many properties are badly deteriorated. There have been several press articles focusing on bad properties. MTM provides an aggressive, comprehensive response to these concerns.

Will MTM save money? Yes.

- In cash terms, the best estimate is that it will save \$33 billion over 25 years compared to the status quo.

over how long?



- Given where the appropriators are headed, however, an equally relevant question is: how much will it save relative to a world in which project-based subsidies are not renewed? A rough estimate is that, in today's dollars (discounted present value) use of the MTM approach to managing the insured assisted portfolio will save \$9 to \$12 billion.

Should we delay in proposing an ambitious solution like Mark-to-Market because the problem is complicated and there are uncertainties? No.

- Continued delay in addressing this problem will hurt tenants to the extent that they remain in properties that lose subsidies.
- It also will hurt owners, to the extent that the properties now have value that will be lost if mortgage costs are not brought into line with rental income. Owners of more marginal properties already have incentives to "milk" them (not make needed repairs); more delay will exacerbate this problem and lead to more tenants being displaced.
- *The insured and assisted market is aware that continuing project-based subsidies is virtually impossible given discretionary spending pressures. They are already adapting their behavior to this reality, and we must do the same. If we do not act quickly, deterioration will not only continue but accelerate. Without a proactive strategy for restructuring the portfolio, HUD would be unable to handle the volume of claims and the Federal government would suffer great losses.*

*W
disagree
obviously*

Will MTM displace tenants? What will be done to protect them?

- In cases where market rents are higher than the voucher payment standard (40th percentile of local market rents), some voucher holders may be unable to pay the higher rents and thus be forced to move. However, given the nature of the buildings and locations, these will be exceptions. Using an assumption that tenants could handle an additional rent burden of up to 10% of their income, HUD estimates that 30,000 households would be displaced over a decade. The cost of displacing some tenants who are subsidized in above-market rent apartments must be balanced against the benefit of providing all assisted tenants -- some who have no choice but to remain in substandard units -- the freedom to choose the best housing they can find.
- Most displacement (about 65,000 households over a decade) will occur regardless of MTM because the property has become physically obsolete. If anything, the rehab. grants, mortgage restructuring, and injection of new market capital provided through MTM will minimize the amount of displacement resulting from property deterioration.
- *Elderly and disabled tenants will have special protections.* Even if rents rise in their units, they be able to stay without paying additional rent as long as the total unit rent

is reasonable compared to similar, non-assisted units. Some elderly may have to move if an obsolete property is removed from the housing stock. Again, this probably would occur in the absence of MTM. Such residents would also wind up in better apartments after moving.

Will MTM harm well-functioning properties and their neighborhoods?

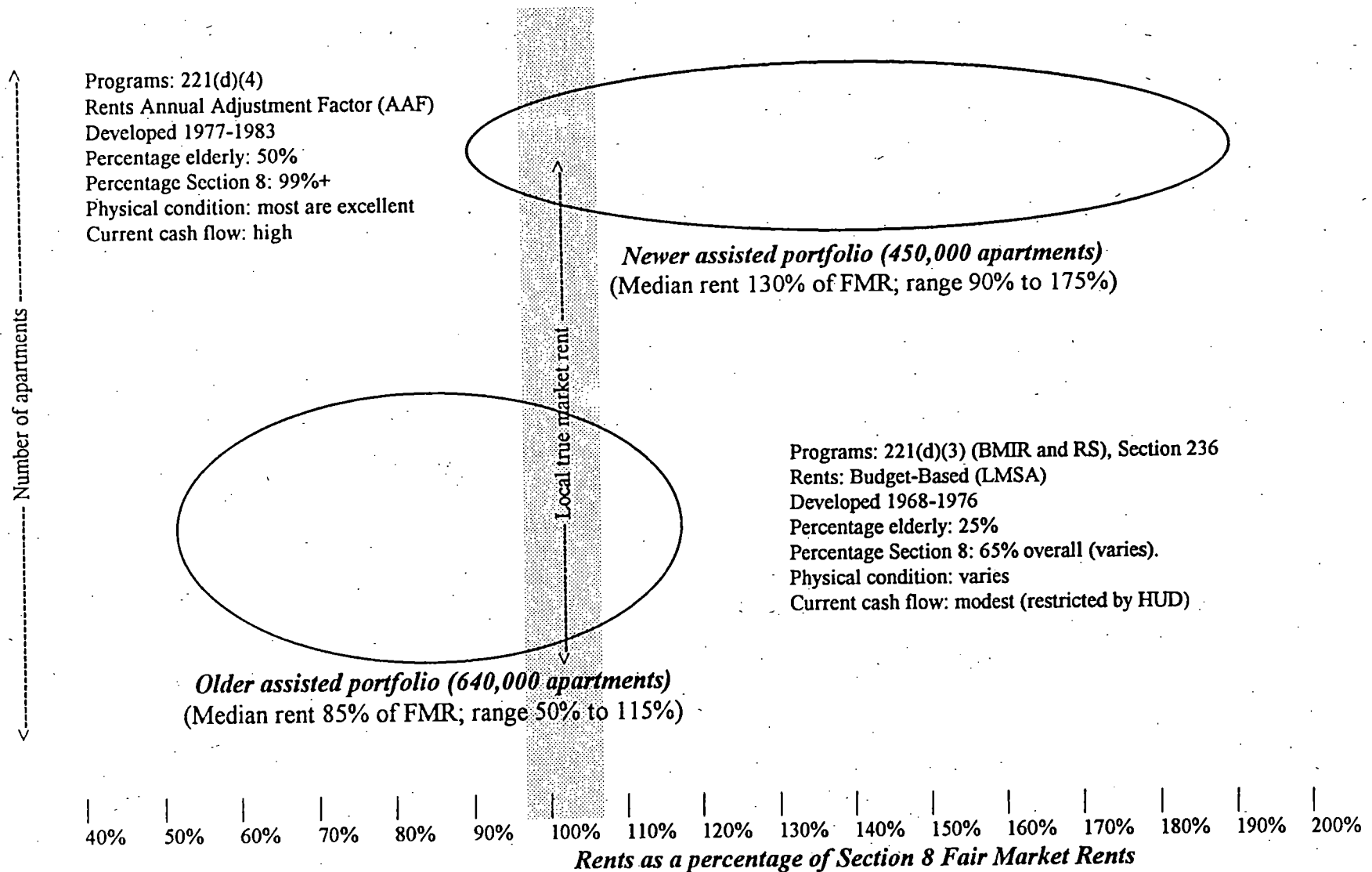
- While there are pervasive problems within the portfolio of insured and assisted properties, not all are poorly managed, low-quality housing. A significant portion of it is well-managed and in good physical condition -- this part of the portfolio works. These properties--the ones that have "played by the rules"--are well positioned to compete in the marketplace and should be able to maintain much of their tenant population.
- Any transition to a new set of operating practices will produce difficulties. MTM includes several positive strategies to minimize adverse impacts. Properties will be eligible for transitional assistance. Provision of limited-term project-based subsidies and rehabilitation grants will prepare many properties for the market and ensure that disruption to tenants and communities is minimal.

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Exhibit 2

Section 8 Mark-to-Market
The Universe of Properties, Schematic Representation



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MARK TO MARKET PRESS BRIEFING MATERIALS

May 30, 1995

What Is Mark-to-Market?

"Mark-to-market" is the Administration's initiative to address chronic structural problems in the federally-assisted housing delivery system. The imminent expiration of a large and costly inventory of long-term Section 8 project-based assistance contracts -- beginning in 1996 and moving beyond the turn of the century -- provides Congress the opportunity to undertake these reform before the crisis becomes acute as the wave of expirations grows.

Why Reform Is Necessary

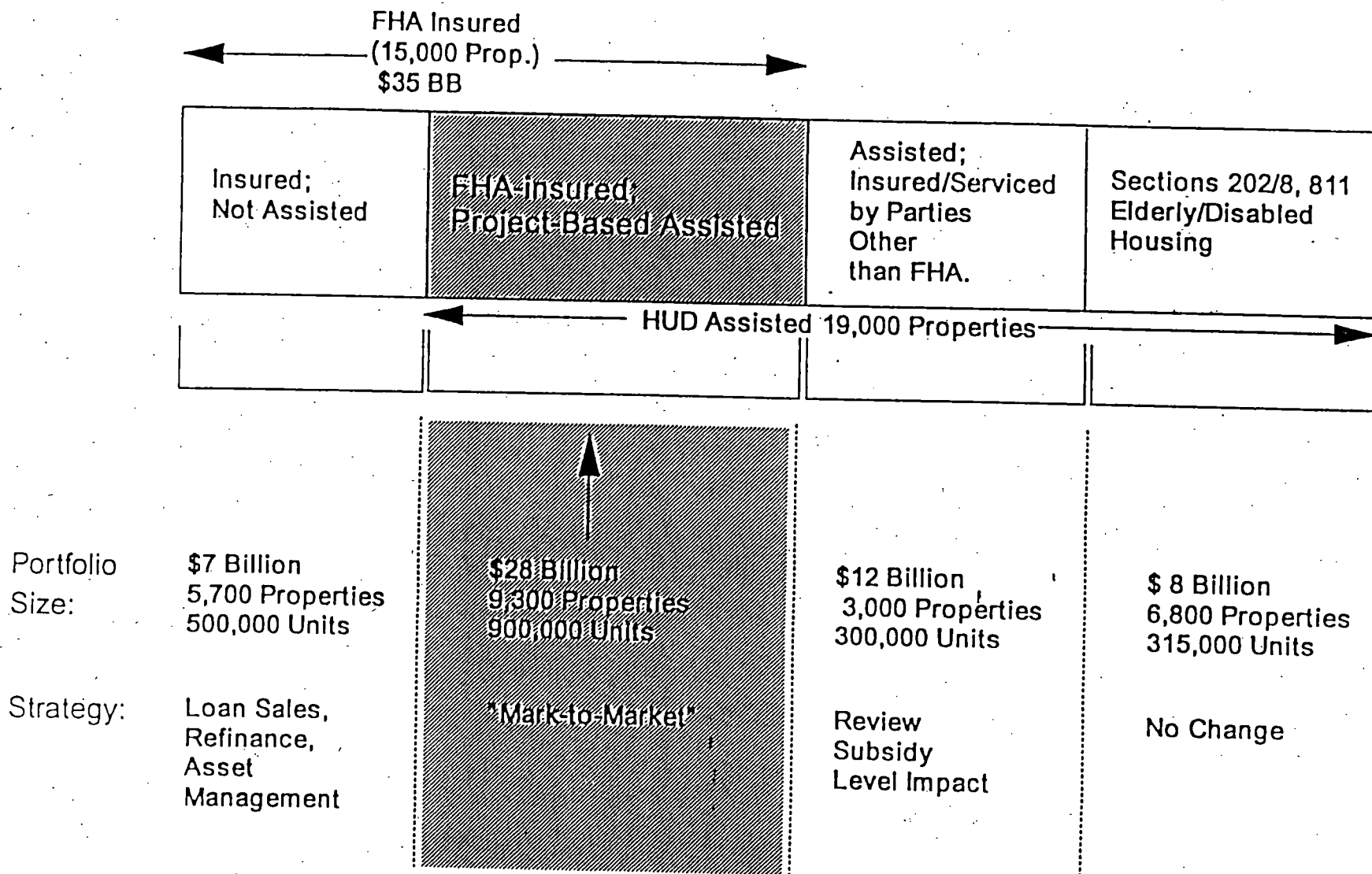
- The long-term economic cost of continuing to provide Section 8 project-based assistance has become untenable.
- The operational flaws and structural problems that have long been apparent in Section 8 project-based assistance have reached critical proportions. On the one hand, many properties receive more federal assistance than is necessary to maintain them as decent affordable housing -- draining scarce federal resources. At the same time, many other properties have fallen into serious disrepair. Because the assistance is project-based, residents are trapped. If they try to leave substandard projects and move elsewhere, they risk losing their rental assistance.
- Because of the absence of market incentives, the assisted housing delivery system is becoming increasingly outmoded. Housing assistance remains a federally-directed, highly regulated system that gives little or no role to local decision makers and ties assistance -- and the families receiving it -- to specific properties.

Properties Affected

Mark-to-market targets properties which receive project-based assistance under the major assistance programs of HUD's Office of Multifamily Housing and whose mortgages are insured by the Federal Housing Administration. FHA's position as mortgage insurer enables the Department to undertake this initiative. Importantly, the insurance provides a vehicle for FHA to facilitate the restructuring of a property's debt to a level that can be supported by market rents once subsidies end. FHA would do so by taking a partial claim against the FHA insurance fund.

The properties in the mark-to-market economic model represent the major assistance programs used in FHA-insured multifamily properties. The vast majority of the more than 9,000 multifamily properties that are both assisted and insured by FHA are included in this initiative.

"Mark-to-Market" Affects Intersection of FHA-Insured and HUD-Assisted Projects



(Numbers are approximate; for general comparison only)

<u>Included in Mark-to-Market Economic Model</u>	<u>NOT Included in Mark-to-Market Economic Model</u>
*Section 236 w/ Loan Management Set Aside (LMSA) *Section 8 NC/SR *Other FHA insured w/LMSA *Section 8 PD	<i>Insured, Not Assisted</i> *Section 236 w/o LMSA *Section 221(d)(3) BMIR w/o LMSA <i>Insured, Assisted</i> *Section 8 Mod Rehab <i>Not Insured,-Assisted</i> *Section 202/811 *Any Section 8 property not FHA insured

Properties which are assisted but NOT FHA-insured are not part of the mark-to-market economic model. However, they would be impacted when assistance contracts are not renewed.

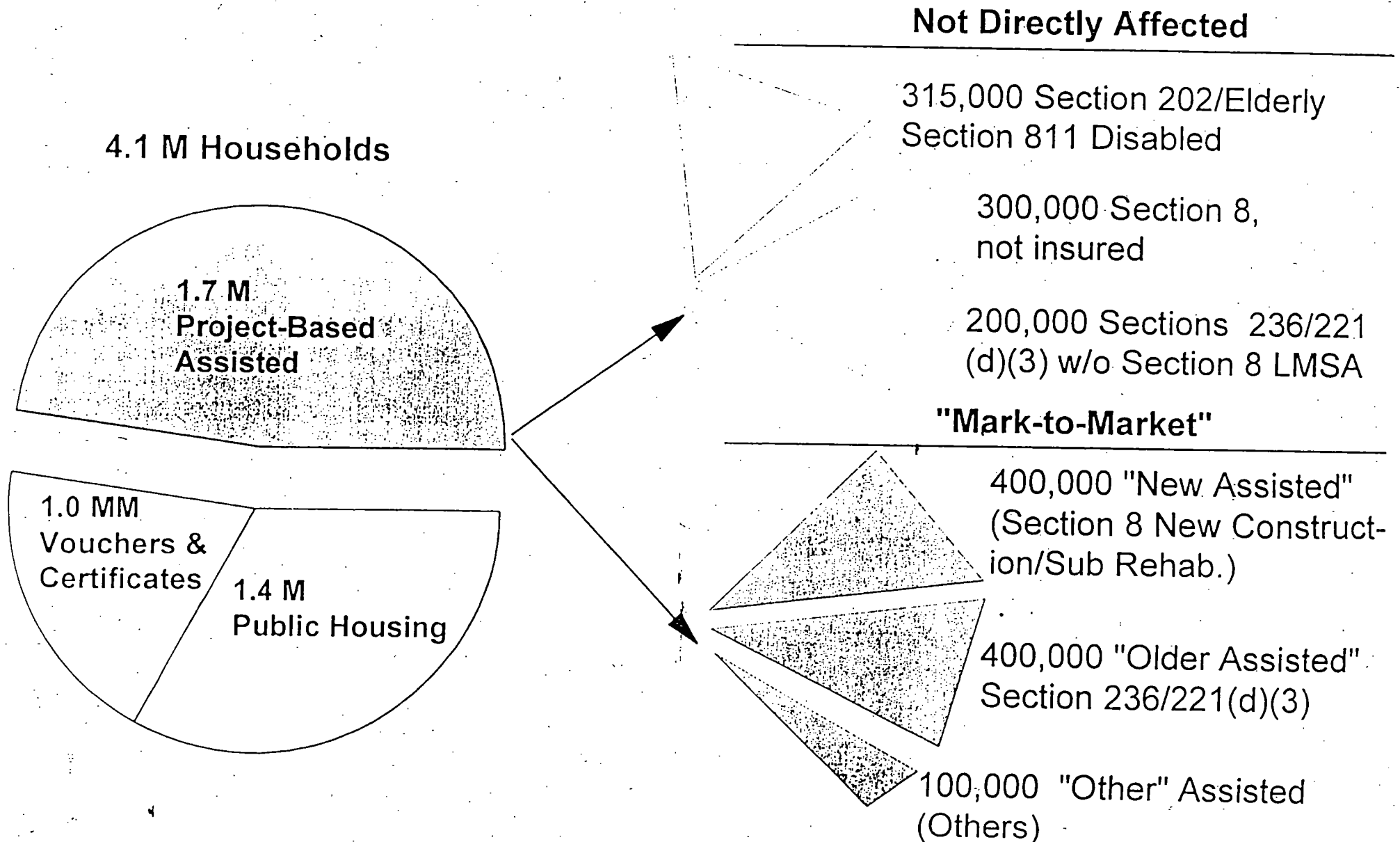
Although they are both FHA-insured and assisted, operational constraints on properties not administered by HUD's Office of Housing have led to the exclusion of the Section 8 Moderate Rehabilitation properties. These may be handled in later phases of restructuring.

No Section 202 properties are included in the mark-to-market economic model. This uninsured portfolio is unique, with budgetary ramifications outside of the Department, and would continue to be assisted under the current system.

Mark-to-Market Elements

1. Section 8 project-based assistance will not be renewed as contracts expire.
2. Properties will make the transition to market.
HUD will assist properties in this transition in a manner which minimizes losses to the FHA insurance fund and helps to preserve the taxpayers' investment in the assisted housing portfolio.
3. Residents in affected properties will receive housing certificates.
Residents in project-based units will receive housing certificates to secure housing of their choice. Special protections would be provided for elderly and disabled residents.

"Mark-to-Market" Affects on y a Segment of Assisted Housing



Why Now?

Action this year is particularly important because the private markets have already come to believe that Section 8 project-based assistance contracts will not be renewed upon expiration. Owners, lenders and investors are incorporating this information into their estimates of assisted housing property values and creditworthiness. Such an environment promotes rapid disinvestment in this portfolio -- instead of the recapitalization that is increasingly required -- and jeopardizes the value of an important housing stock created with substantial taxpayer investment.

Mark-to-Market Objectives

- Stop oversubsidizing projects
- End projects' permanent reliance on project-based assistance
- Help projects that are economically viable achieve a sound market footing
- Promote tenant choice in locating housing
- Reintroduce private market competition

In May, the Department submitted draft legislation -- the American Community Partnerships Act -- that would ensure the authority needed to carry out all elements of the mark-to-market initiative.

Mark-to-Market Principles

- 1. A Portfolio Approach Is Better Than A Property-by-Property Approach.** The universe of properties that would be impacted by mark-to-market is large and diverse. The optimal approach for resolving this complex portfolio is not to try to design an individual strategy for each affected property or mortgage. Rather, the Department has examined and considered the insured/subsidized portfolio as a whole and designed options on the basis of portfolio-wide property groupings.
- 2. The Private Sector Will Implement Mark-to-Market, Within Clear Boundaries Established in Federal Policy.** To the maximum extent possible, the work needed to implement mark-to-market would be undertaken by private institutions and state and local agencies, within clear rules and principles established by Congress and HUD. The private markets, not HUD, are best equipped to transition this housing stock to a sound private market basis.
- 3. Mark-to-Market Will Be Undertaken Rapidly -- But Not Recklessly.** Expedient transition of the project-based housing portfolio is important to protect the stock from disinvestment. The mere fact that HUD and Congress are even considering changes to the Section 8 program is causing the private markets to change behavior toward this portfolio. The transition must not be so rapid as to jeopardize residents and neighborhoods, but HUD recognizes that too slow a conversion can create a climate where properties deteriorate and lose value. The ideal mark-to-market program would resolve as many situations as possible proactively, while not abrogating contracts.

4. **Portfolio Resolution Will Be Designed To Be Feasible within the Framework of HUD's Future.** The mark-to-market operating plan will be designed so that it can be implemented even if the Department undergoes significant reengineering and/or downsizing.
5. **Mark-to-Market Is Predicated On Congress Providing Certificates For All Eligible Residents In Affected Properties.** The plan recognizes the importance of continued resident access to housing. The success of mark-to-market depends on Congress appropriating an annual level of a certificates that is sufficient to cover all eligible residents in units which lose project-based assistance and transition to market -- and to do so over the full time frame of the transition.
6. **Private Parties Participating in Mark-to-Market Will Be Competitively Selected.** The implementation of this plan anticipates substantial private sector involvement, including partners, contractors, investors and bidders. Private sector participants would be competitively chosen based on criteria identified in advance of the selection process.
7. **Conversion to a Market Based System Will Benefit Residents and Neighborhoods.** The private multifamily market underwent a mark to market process beginning in the late 1980s and early 1990s. With the curtailment of real estate tax shelters and the end of inflation driven profits, private multifamily owners were forced to compete on the basis of providing better housing and services to residents at lower cost. Assisted housing lags behind the conventional multifamily industry in this transition because much of its performance is still driven by the need to satisfy government formulas and regulations. One byproduct is that assisted housing is becoming increasingly expensive to operate and maintain compared to conventional housing.
8. **Current Contracts Will Not Be Abrogated.** A timely transition to market will not be achieved by abrogating existing federal financing or assistance contracts. Any resolutions would be based on voluntary agreement to participate or on terminations of existing contracts.
9. **Real Estate Use Restrictions Will Be Disconnected From Mortgages.** One goal of mark-to-market is to decouple rules and restrictions that apply to underlying properties from the mortgages themselves so that the private competitive marketplace can determine the optimal use and capitalization for the real estate.
10. **Recourse Will Be Minimized.** To the greatest extent possible, mortgages will not carry FHA insurance after mark-to-market. This will enable the real estate to transition to market and avoid the valuing of mortgages on the basis of the presence of FHA insurance, rather than the underlying real estate value of the asset.
11. **Aggressive Enforcement Is Necessary To Protect Current Residents, Minimize Losses and Preserve Taxpayer Investment.** An integral part of mark-to-market is HUD's aggressive enforcement of existing regulatory and contractual requirements imposed on owners, servicers, and lenders that provide protections for the value of the property. HUD will actively enforce its requirement that mortgage servicers declare non-monetary defaults and assign mortgages for properties that are not maintained as safe, decent and affordable housing.
12. **Mark-to-Market Will Promote Rehabilitation of The Assisted Housing Stock.** The mark-to-market plan will be designed to encourage the rehabilitation and recapitalization of the assisted

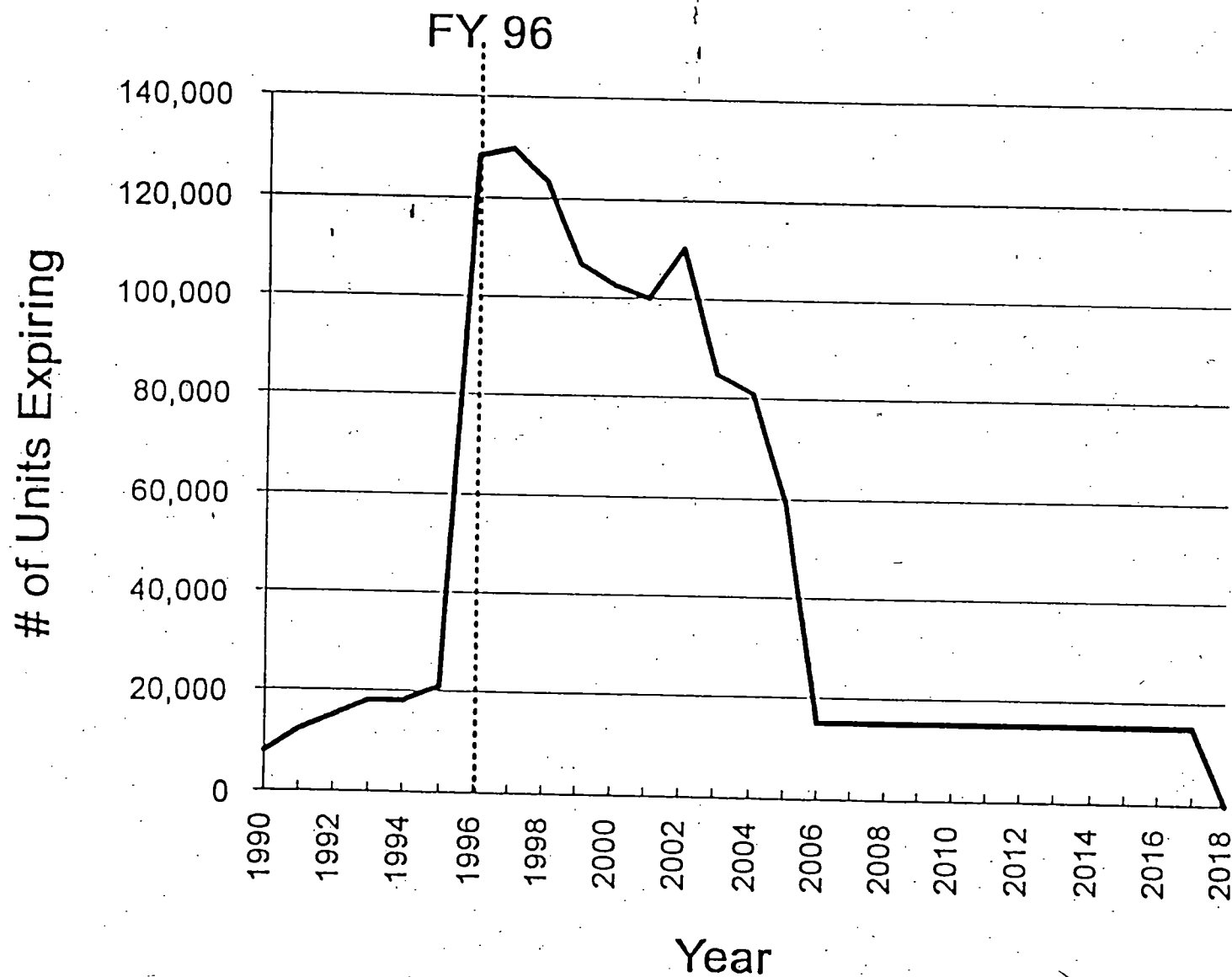
housing stock. Such reinvestment will be undertaken primarily with private capital. Rehabilitation grant funds may also be available to assist in this process.

13. Properties Which Are Not Feasible for Restructuring Will Be Allowed To Leave The Stock. If, despite the tools and resources available to the restructuring effort, a property cannot reasonably produce sufficient income to cover the operating expenses absent debt payments, alternative resolution methods would be pursued. These could include canceling the debt, demolition and subsequent sale of the land, or transfer of the property (with tenant-based assistance only) to a responsible third party, such as a nonprofit or local government organization.

14. Tax Issues Will Be Resolved by The Principal Parties. Mortgage restructuring may trigger tax consequences. In a mortgage loan sale, winning bidders would determine with owners how to resolve outstanding tax issues, if any. The Department is not proposing amendments to the tax code, recognizing the potential for unintended consequences.

15. Special Protections Will Be Provided To Elderly and Disabled Residents. Elderly and disabled residents comprise a significant percentage of the residents of properties receiving federal project-based assistance. Because of the specialized nature of their housing, such residents could have difficulty locating suitable alternatives if forced to move from their current apartments in the event that the new "market" rents exceeded levels supported by the newly provided housing certificates. Special provisions for this circumstance are addressed in the plan.

Expiring Section 8 Contracts: Crisis and Opportunity



Memo: alert govt to issues that may require your advice/counsel

Lari / Steve / Adam →
- Boderberg paper
- mby

What it is: over next 10 yrs, 1.4 M ^{hsg units} Sec 8 contracts expire
MTM → 900,000 units

Industry / Allocater

- costs 5 times higher b/c of ^{new} ~~regts~~ ^{regts} in constr + special series for elderly
- major disruptions for tenants
- question savings CCBO → \$4B more than revenue P-6 ass)

FHA constr stds + wage regts

HVD / Fed 180 it

program designed to produce hsg in areas where priv invest unwilling or unable to perform

Budok: "antithesis of the preservation of existing aff'ble hsg"
• failure of mkt to build low inc hsg that req'd HUD involvement in bldg

HVD: ^{1st + growing losses in most of which serves low inc hsg bldgs} ^{increased multifamily} FHA portfolio ↑ forces LT prob → if not addressed, will result in damaged hsg stock + large costs to fed govt

- HVD has budget + staffing probs that limit ab'l to address
- will save govt \$
- oversubsidized
- \$9-12B savings
- HUD/OMB → 30,000 units displaced

manage current stock + admin capacity shrinking

Status: H long supports/authorizes conversion of rental subs to voucher

Bottomline: ^{disgr spends} budgeting realities will not allow continuation of rental subs @ current rate

→ unsure abt disinvestment

→ very complex; little will understanding

→ not likely ^{but creates tremendous antagonism} - but creates tremendous antagonism

→ one there ways to maintain aff'ble hsg stock
Is it best from cost as well as other perspectives?

→ OMB/HVD protection removed

?s Diff's down older + newer assisted hsg stock
rents below mkt
btr fin'ly + physically; lower inc tenants
contract rents gen'ly above

2 related probs -
1- LW → sure that 1,23 not same of HUD probs
2- this issue

older asst'd. hq. $\rightarrow$ $\frac{1}{2}$ of ^{900,000} stock $\rightarrow$ below mkt interest rates
 $\rightarrow$ would mean making up to mkt - no sense
(HUD $\rightarrow$ 70-80% are below) $\rightarrow$

GAO: excluding older props would cost \$4B less over 25 yrs

Newer stock - HUD: 75% have rents $>$ fair. Most contracts
expire late in decade (98-2000)
FY 96 - 957 units expire

Danbar suggestion: for good props, renew Sec 8 proj-b each
at rent levels reflecting lowered ...

We Must Preserve the Nation's Supply of Affordable Housing

by Michael Bodaken, President, National Housing Trust

For 60 years, Congress has recognized that meeting America's housing needs requires a federal partnership with the private housing industry and state and local governments. This has come through a combination of mortgage insurance, direct investment of capital, tax incentives, a write-down of mortgage interest, or other assistance. Today we are engaged in a debate over the future of that partnership, the people it serves, and the millions of units of housing it has produced.

The Department of Housing and Urban Development (HUD) is proposing a profound shift in policy on housing built and owned by the private sector, both for-profit and nonprofit. Built over two decades with federal mortgage insurance receiving project-based Section 8 rental assistance, this housing has served millions of low-income people and has had broad bipartisan support during both Republican and Democratic Administrations.

HUD's new policy is spurred by the expiration of Section 8 contracts on a total of over 1.4 million assisted housing units over the next 10 years.

The Department's proposal for FHA-insured and Section 8 assisted housing is to eliminate project-based assistance as contracts expire; eliminate regulatory requirements governing the housing; pay mortgage claims triggered by the elimination of subsidy; provide some rehabilitation to a portion of the stock; and provide residents with Section 8 certificates administered by local public housing authorities. (For budgetary reasons, HUD simultaneously proposes to reduce the voucher ceiling.) The idea is to mainstream this housing into the conventional real estate market, without subsidies or use restrictions. The plan reverses a long-standing policy on maintaining a supply of well-located and maintained housing for current and future low-income renters. The new policy, called "Mark to Market," is the antithesis of the preservation of existing affordable housing, an explicit goal adopted by the Congress over a decade ago.

All parties in this debate agree that reform of HUD programs is necessary, that maintaining the status quo is unacceptable from a fiscal and housing quality perspective. But is an approach that could eliminate the affordable housing supply the best solution? Is it the best solution from a cost perspective as well as from the perspective of renters, owners, neighborhoods, local governments and the national interest in having an affordable housing supply and delivery system? Also, are there policy distinctions to be made based on the characteristics of the federally-insured housing stock, including age, condition, type of financing, and other subsidies? We believe there are and that HUD's goals for reducing costs and providing more flexible housing opportunities can be achieved without "throwing the baby out with the bath water."

How Did We Get Here?

The federal housing story begins in 1937 with the National Housing Act. The Act committed the United States "to remedy the unsafe and unsanitary conditions and the acute shortage of decent, safe and sanitary dwellings for families of low income in rural or urban communities, that are injurious to the health, safety and morals of the citizens of the nation."

In 1949, Congress established as a cornerstone of national policy "the realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family."

Congress reaffirmed this policy in 1968, declaring that "the highest priority and emphasis should be given to meeting the housing needs of those families for which the national goal has not become a reality."

Between 1965 and 1974, private builders were offered below-market interest rate insured loans for affordable units reserved for low-income families and seniors. The program was highly successful, generating the development of over 600,000 homes during this decade. Later, due in part to the oil crisis, utility price hikes and other operating expense increases led to the need for additional federal property based subsidies to keep the units affordable. Section 8 contract rents for these units are generally below market and "budget-based," i.e. rent is based on budgeted expenses and the owner's limited dividend. These properties are typically referred to as "older assisted housing."

Apartments created under the Section 8 New Construction/Substantial Rehabilitation (NC/SR) program, made part of the Housing and Community Development Act of 1974 during the Nixon/Ford Administrations, are typically referred to as "newer assisted housing." Designed for private operation, this program provided federal insurance as an option. All these units received project-based subsidies. This program produced almost one million apartments between 1974 and 1983. Unlike the older assisted stock, the newer assisted stock has fewer financial and physical problems. Another contrast is that incomes of tenants in newer assisted stock are generally lower than incomes of tenants in older assisted stock. Unlike the older assisted stock, most contracts on newer stock do not begin to expire until 1998. Finally, for a variety of reasons, contract rents for newer assisted stock are often above market, whereas contract rents for older assisted stock are typically below market.

What Would Happen Under Mark to Market?

HUD proposes to eliminate all use restrictions, except income eligibility, for any FHA insured property partially or fully assisted by project-based Section 8. This applies to both the newer and older assisted housing stock. The drive to market is nowhere better expressed than in HUD's proposed legislation, which allows the HUD Secretary to "remove at the owner's request, or at the Secretary's determination, any [emphasis added] mortgage restriction, regulatory agreement restriction, project based contract or use agreement restriction from projects undergoing restructuring [Mark to Market] if such restriction would prevent the project from operating as a market rate rental project."

If the housing defaults, HUD proposes to sell the mortgages. Whether the mortgage sales will be driven purely by economics or by a public interest /market admixture remains unclear. Mark to Market assumes a market in which this real estate will find its "natural" level. Federal rent formulas will be abandoned, the owner will be entitled to an unlimited distribution, and affordability restrictions are eliminated. While owners may be required to rent to those earning below certain incomes, residents may have to pay rents in excess of 30% of their income to stay in place.

The Difference Between the "Old" and the "New" and Budget Realities

The Mark to Market proposal tends to blur three essential points:

(1) HUD asserts that "Mark to Market" will reduce ongoing Section 8 subsidy costs by cutting rents down to market and writing down FHA mortgages to a property's true economic value. This is only half true.

Despite their essential differences, HUD proposes to "mark to market" both older and newer assisted housing stock. Approximately one-half of the 900,000 units are in the older assisted category, projects built in the 1960s and 1970s with below market interest rates.

There is no budgetary or policy rationale for "marking UP to market" older assisted housing. Raising rents would negate the benefits of the financing structure of these projects; eliminating property based Section 8 and substituting vouchers would be a waste of precious budget resources in an increasingly stingy budget climate.

HUD acknowledges that 70-80 percent of contract rents in the older, assisted housing stock are below local fair-market rents. In its latest report on "Mark to Market," HUD declares that nine out of 10 residents will choose to stay in the units they presently occupy. Assuming this to be true, the federal government will pay more for a voucher to a family currently residing in the older assisted housing stock than the current rent. Additional costs of marking to market the older assisted stock have been noted by the General Accounting Office, which observes that "excluding the older assisted properties from [Mark to Market] would cost \$4 billion less over 25 years (on a net present value basis) than including them."

2) HUD assumes that tenant-based subsidies are "the future." But HUD has already carved out property-based "exceptions" for the elderly and the disabled, block granting them to local governments. Ironically, as a rule, state and local governments use place-based assistance, i.e., through the allocation of low income housing tax credits, HOME, CDBG and other resources that essentially provide up front capital subsidies for housing with long-term rent restrictions.

Vouchers are a valuable tool in any affordable housing delivery system. But they are not a substitute for maintaining a supply of affordable housing, especially when choices must be made about how to invest limited resources. If we are not going to supplement incomes enough to permit the private housing market to meet the housing needs of low-income Americans, national housing policy must include well-designed and implemented programs to preserve the existing supply of affordable housing.

3) HUD assumes that few residents will be displaced by Mark to Market. But HUD's recent displacement bulletin bases this claim on the questionable assumption that renters would assume a rent burden of up to 40 percent of income before they would relocate. There is no basis to assume that low-income residents have incomes sufficient to pay these higher rents.

Higher rents are a certainty for tens of thousands of apartments. In a case example document released June 21, 1995, HUD estimates that the rents for older assisted housing would increase between 8 and 34 percent, depending upon the location and condition of the property. To mitigate these impacts, HUD proposed that, as contracts expire, households in Section 8 units and others who are or become rent burdened would receive

two-year vouchers. Further, HUD posits that vouchers work best with adequate counseling and where discriminatory barriers are reduced. Thus, HUD requested from Congress tens of thousands of additional vouchers to make Mark to Market work with older assisted housing. In July, the House Appropriations Committee rejected HUD's request and voted for no additional Section 8 certificates, thus denying certificates for households that become rent burdened due to Mark to Market rent hikes. Instead, the Committee gave the Secretary "discretion" to voucher out assisted housing at HUD's proposed lower voucher levels. Due to budget politics, this type of Mark to Market "Lite" (less housing, reduced voucher assistance), may well be the legislative outcome.

Based on more realistic ratios of rents to income for the entire assisted housing stock, including stock lost due to deterioration, the National Housing Trust estimates displacement to be well over 175,000 households. Without any testing of the mark to market concept, there is no telling how much displacement will occur.

Timing and Alternatives:

Different subsidy contracts expire at different times. HUD estimates that 75 percent of newer assisted projects have rents in excess of FMR. Most of those contracts do not expire until later in the decade. According to the Congressional Budget Office, only 957 newer, assisted apartments in the entire country have contracts that expire in FY 1996 and the peak years are FY 1998-2000 for renewal of contracts on the newer assisted stock. Nevertheless, HUD asserts that decisions must be made this summer to avoid negative capital market consequences. The Trust believes that a hastily-set policy will lead to numerous mid-course corrections, which would be more harmful than taking time to develop a well-conceived policy.

Unfortunately, the older, assisted housing stock, for which rents will be increased, would be the first candidates tested by Mark to Market. According to the CBO, fully 220,000 units of older assisted housing expire during the next two years. The possibility that HUD will abandon the preservation of this mixed-income, federally-assisted, multifamily housing that serves primarily the working poor—and incur a greater expense to the taxpayer in doing so—leaves affordable housing preservationists shaking their heads.

Now is the time to bring other approaches to the table.

- The National Housing Trust has advanced a capital grant proposal that would provide for rehabilitation of the older assisted housing stock, demand permanent affordability in return, maintain the current below market rents in place, and cost approximately 15 percent less than Mark to Market.

- A variant of this approach would be to segment the older assisted stock into three tiers. The top tier, excellent properties in strong markets, are candidates for a capital grant. The second tier could have debt written off in return for substantial repairs, keeping below-market rents in place. The third are those properties that might not be able to sustain operating expenses, even if debt is written down to zero, but that serve as anchors in weak markets. These properties may need continued property based assistance, albeit at lower levels.

- A third proposal would permit owners of the older assisted stock to mark rents up a little, not all the way to market, with continued property based assistance to attract private financing for rehabilitation.

cost?

• Another proposal would permit property owners to provide "turnover certificates" to poorer residents to avoid low-income concentration. When very low-income people moved out with their certificates, the property owner could move in a slightly higher income resident who could afford the budget-based rent without federal subsidy;

• A draft concept, currently in circulation on Capitol Hill, permits owners of high value properties to opt out, but provides rehabilitation and operating funds for "good owners" of lower value developments which are the best properties in weak market;

and

• Finally, the National Housing Trust, local governments and nonprofits have asked that restrictions be lifted to permit the mix and match of HOME funds and tax credits to preserve federally assisted housing.

The Trust compliments the Administration's efforts in beginning to wrestle with the policy and financial challenges of HUD assisted housing. But HUD's Mark-to-Market proposal should be unbundled and each element should be evaluated for cost-effectiveness, administrative feasibility, and its impact on the future of this housing stock. As presently framed, Mark to Market is not the most cost-effective approach, and it would not necessarily serve the interests of current residents, the neighborhoods in which the housing is located, or local governments, which may realize increased burdens without adequate resources.

Michael Bodaken is the President of the National Housing Trust. The National Housing Trust is a national nonprofit organization dedicated to the preservation of existing affordable housing. The Trust provides technical assistance to nonprofits, residents, and state and local housing entities throughout the U.S.

For more information about Mark to Market, check out the Assisted Housing Folder on HandsNet or call the National Housing Trust at 202/333-8931.

August 15, 1995

NOTE TO KUMIKI GIBSON

FROM: Steve Redburn

COPY: Bob Litan

SUBJECT: Status of HUD Mark-to-Market (MTM) Proposal

As you know, HUD has presented a proposal to the Congress, as part of its reinvention legislation, to deal with large and growing losses in the FHA-insured multifamily portfolio, most of which serves low-income households. The attachment to this note provides you with a description and background on the proposal.

Although MTM would produce long-term savings, the proposal faces an uphill battle this year for at least three reasons: (1) opposition from interests such as property owners who would benefit from delay; (2) technical scoring conventions that make it difficult for the Congress to get credit for the long-term savings; and (3) the inherent complexity and reach of the proposal. Moreover, the full policy requires coordinated action by appropriators and authorizers.

Despite these difficulties, the House appropriators' actions and language were consistent with MTM. Most importantly, the House appropriations bill renews expiring rental assistance contracts as tenant-based portable assistance. Both their bill and the Budget Resolution include language that indicates general support for the policy.

On the Senate side, there is less support. Senate appropriators (Senator Bond and Clerk Stephen Kohashi) have asked HUD to develop compromise language that would restrict MTM to demonstration status in 1996 and would in some cases continue to tie rental assistance to particular projects (rather than make it portable).

Having discussed possible elements of a compromise with Senator Bond and his staff, HUD has provided us with the draft compromise language, which we have reviewed. We and the Department are consulting with CBO staff regarding their scoring treatment of this language. If it appears that CBO will provide the desired scoring, this language will be presented to Senate appropriators later this week.

We and HUD agree that any compromise should retain these essential elements of MTM: (1) authority for HUD to test the MTM approach to restructuring mortgages proactively; (2) discretion for HUD to renew most if not all expiring project-based subsidies as portable vouchers; and (3) relief from current statutory restrictions on property disposition, loan sales, and mortgage restructuring.

Attachment

HUD'S MARK-TO-MARKET PROPOSAL

The Administration's Mark-to-Market (MTM) proposal will restructure mortgages of up to 9,000 high-cost and overmortgaged FHA-insured multifamily properties. Assisted tenants will be given portable vouchers.

- Mark to Market (MTM) will address long-standing problems in the portfolio of 9,000 properties which have mortgages insured by FHA and receive rental subsidies for low-income tenants. The mortgages of these properties will be written down to reflect their true economic value, resulting in mandatory claims being paid out of the FHA fund. At the same time, assistance provided to tenants will be converted to portable vouchers. This will generate discretionary savings: many properties receive subsidies in excess of market rents though others are actually below market. MTM uses market mechanisms to restructure mortgages, create incentives for owners to provide quality and efficient housing stock, and provide assisted tenants choice in their housing.
- The Administration estimates that MTM will save the Government, in present value and total cost terms, between \$9 and \$12 billion. The Administration has scored MTM as neutral on a PAYGO/credit reform basis.

Cost of Delay

- For several reasons, delays in MTM would be very costly. Therefore, while recognizing that we may not get the whole proposal, the Administration continues to support enactment this year of the major components of the MTM approach.
 - Financial losses and physical deterioration of federally assisted properties are already occurring and will worsen without the proactive approach of MTM.
 - The problems addressed by MTM are hard to solve by incremental proposals. Any attempt that does not address the structural flaws of project-based rental assistance and the inherent inefficiencies of HUD management will leave critical weaknesses.
 - FHA mortgage defaults are increasing even without MTM as HUD takes aggressive enforcement action against bad properties. *HUD is ill-equipped to manage its current workload, let alone even modest increases.* Furthermore, HUD's administrative capacity is shrinking. Over the next few years, HUD staff will be reduced sharply under both Administration policy and likely Congressional action.

- MTM would grant HUD the authority to partner with private firms, who would have more flexibility and work under performance incentive contracts.

Status

- Passage of MTM is dependent on both appropriations and authorizations action as well as favorable budget scoring.
- In the House, support is generally strong. The Banking Committee supports the proposal and is exploring its inclusion in Reconciliation. The Appropriations Committee mark for HUD authorizes the conversion of rental subsidies to vouchers and provides no funding for expenses related to the disposition of FHA-held properties (MTM converts this to mandatory spending).
- Support is less strong in the Senate. In particular, the appropriators support the short-term renewal of project-based rental subsidies -- assistance linked to specific properties that tenants lose if they move.
- The Budget Resolution does not include specific dollar amounts to accommodate MTM. It does, however, include text stating awareness of the problems addressed by MTM, support for market-based solutions, and acknowledgement that scoring rules may inhibit passage of authorizations in this area. We have interpreted this to mean that the Budget Committees would not let sound policy be derailed by scoring conventions.
- Congressional opposition to MTM seems to be based as much on the uncertainties of a complex policy change as on commitment to the status quo. The Chair (Senator Bond) and staff of the Senate VA/HUD Appropriations Subcommittee have indicated they may renew most expiring assistance contracts, at least for another one year, in a manner that keeps subsidies tied to specific housing projects. (They may make an exception for high-cost Section 8 New Construction projects -- only 2,800 units expiring in 1996.)
 - Although MTM will produce long-term savings, the appropriators save nothing by making subsidies portable now. *This is a classic budgetary dilemma: preserving the status quo costs virtually nothing in the short-term, even though it will cost several billion dollars over the long term.*
- Strong opposition also comes from project owners, who have received significant financial benefits from a system that shields them from virtually all market risks. While they use delay to extract the last profits from

deteriorating or oversubsidized properties, owners argue that we should take it slow and test new approaches.

- If we determine that political opposition is too much to overcome this year, we should pursue attempts at compromise in a way that positions us well for the future. *We should also avoid public statements that suggest we are backing away from the basic principles of reinvention, including tenant choice and reliance on the market to set rents and determine what real estate is viable.*

Criticisms and Responses

The status quo works and can continue.

- A number of properties are in poor condition and do not have the cash flow to support rehabilitation. Owners have a captive clientele--their incentives for good performance are weak. This will soon become a more visible symbol of failure, like public housing.
- Pressures on discretionary spending will not allow the continuation of rental subsidies at their current rate.

We have time to go slowly and pilot various approaches to restructuring the portfolio.

- The market is aware of the budget realities and the likelihood that subsidies will not continue at their current level. Owners are already adapting by deferring maintenance in an attempt to squeeze out the last bit of profit before an anticipated default.

Restructuring will lead to neighborhood disinvestment as properties lose tenants and fail.

- The transition to market will not be radical and sudden. Properties may receive limited-term rental assistance and rehabilitation grants, preparing them to compete in the market. MTM will minimize the disruption to tenants, communities and owners.
- Many properties are well-managed, quality projects. These are well situated to attract and retain tenants.

Tenants in properties with rents above the level provided by vouchers will be displaced.

- Most tenants who move (65,000 units) will do so because the properties are obsolete. Moving is inevitable under any housing policy and will result in better living conditions.
- Some tenants will be able to absorb rent increases. HUD estimates only 30,000 units (out of a total of 900,000) will have to move because of higher rents.
- The elderly and disabled will have special protections. They will be able to stay in their apartments without rent increases as long as the unit's rent is reasonable compared to similar, non-assisted properties.
- The cost of displacing some tenants who are subsidized in above-market rent apartments must be balanced against the benefit of providing all assisted tenants--some who have no choice but to remain in substandard units--the freedom to choose the best housing they can find.

HUD'S MARK TO MARKET PROPOSAL

Description

- Mark to Market (MTM) will address long-standing problems in the portfolio of 9,000 properties which have mortgages insured by FHA and receive rental subsidies for low-income tenants. The mortgages of these properties will be written down to reflect their true economic value, resulting in mandatory claims being paid out of the FHA fund. At the same time, assistance provided to tenants will be converted to portable vouchers. This will generate discretionary savings: many properties receive subsidies in excess of market rents though others are actually below market (see Tab D). MTM uses market mechanisms to restructure mortgages, create incentives for owners to provide quality and efficient housing stock, and provide assisted tenants choice in their housing.
- The Administration estimates that MTM will save the government, in present value and total cost terms, between \$9 and \$12 billion. The Administration has scored MTM as neutral from a PAYGO/credit reform basis.

Status

- Passage of MTM is dependent on both appropriations and authorizations action as well as favorable budget scoring.
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The status quo works and can continue.

- A number of properties are in poor condition and do not have the cash flow to support rehabilitation. Owners have a captive clientele--their incentives for good performance are weak. This will soon become a more visible symbol of failure, like public housing.
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We have time to go slowly and pilot various approaches to restructuring the portfolio.

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➔ Restructuring will lead to neighborhood disinvestment as properties lose tenants and fail.

- The transition to market will not be radical and sudden. Properties may receive limited-term rental assistance and rehabilitation grants, preparing them to compete in the market. MTM will minimize the disruption to tenants, communities and owners.
- Many properties are well-managed, quality projects. These are well situated to attract and retain tenants.

Tenants in properties with rents above the level provided by vouchers will be displaced.

- Most tenants who move (65,000 units) will do so because the properties are obsolete. Moving is inevitable under any housing policy and will result in better living conditions. *- where to?*
- Some tenants will be able to absorb rent increases. HUD estimates only 30,000 units (out of a total of 900,000) will have to move because of higher rents.

- ➔ ● The elderly and disabled will have special protections. They will be able to stay in their apartments without rent increases as long as the unit's rent is reasonable compared to similar, non-assisted properties.
- The cost of displacing some tenants who are subsidized in above-market rent apartments must be balanced against the benefit of providing all assisted tenants--some who have no choice but to remain in substandard units--the freedom to choose the best housing they can find.

Mr. Jim Arbury
Vice President, Tax
National Multi Housing Council
National Apartment Association
Suite 540
1850 M Street NW
Washington, DC 20030

Dear Mr. Arbury:

Thank you for your letter regarding the tax consequences of the Administration's "mark to market" (MTM) proposal. MTM has several objectives: to provide assisted tenants with choice in the rental market, to use market incentives to encourage the provision of quality housing stock, and to effectively manage and anticipate problems within the Federal Housing Administration (FHA) insurance fund.

The FHA portfolio of insured and assisted multifamily properties faces several long-term problems. If not addressed promptly, these will result in damaged housing stock--with severe effects on neighborhood quality--and large costs to the Federal Government. A significant number of insured properties have avoided default only through the application of large, above-market subsidies. If the current path were to continue, the cost of subsidies would continue to grow and physical stock problems would continue.

MTM addresses these problems by tying rental assistance to market rates and exposing insured properties to market forces, including allowing renters the option of choosing the best apartment they can find. Financial analysis of MTM confirms that it will save the government money. This analysis did not include any assumption of taxes collected from forgiven debt.

The transition to the marketplace may be difficult in some cases, but will be eased by several policies. Mortgages will be reduced to reflect their value in the open market. Two forms of transitional assistance may also be provided: rehabilitation grants and short-term, project-based rental assistance. Many insured, assisted properties are currently functioning well and will find it easy to attract renters, making the transition with a minimum of difficulty.

This assistance will help minimize the disruption to neighborhoods, tenants, property managers and owners. Other proposals to restructure the multifamily insurance portfolio do

not include these forms of transitional assistance. These approaches would have a sudden and drastic impact.

Tax consequences may result from restructuring. Under MTM, such issues would be resolved by the principal private parties. You may wish to discuss this particular issue further with the staff of the Department of Housing and Urban Development. I would also be happy to have my staff review any proposals you may wish to bring to my attention in this area. Thank you for your interest.

Sincerely,

Robert E. Litan
Associate Director
General Government and Finance



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

JUN 28 1995

Mr. John McIlwain
Powell, Goldstein, Frazer, and Murphy
Sixth Floor
1001 Pennsylvania Avenue, NW
Washington, DC 20004

Dear John:

Thanks for your kind words about my presentation. I understand your concerns about mark-to-market (MTM). Let me counter with some of our thoughts on the matter.

MTM has several objectives: to provide assisted tenants with choice in the rental market, to use market incentives to encourage the provision of quality housing stock, and to effectively manage and anticipate problems within the Federal Housing Administration (FHA) insurance fund.

The FHA portfolio of insured and assisted multifamily properties faces several long-term problems. If not addressed promptly, these will result in damaged housing stock--with severe effects on neighborhood quality--and large costs to the Federal Government. A significant number of insured properties have avoided default only through the application of large, above-market subsidies. If the current path were to continue, the cost of subsidies would continue to grow while physical stock problems would not be reversed.

MTM addresses these problems by tying rental assistance to market rates and exposing insured properties to market forces, including allowing renters the option of choosing the best apartment they can find. MTM is an integrated strategy, all its elements are necessary for its success. Financial analysis of MTM confirms that it will save the government money.

The transition to the marketplace may be difficult in some cases, but will be eased by several policies. Properties will not simply be turned over to the marketplace. Long-standing problems of physical and financial viability will be addressed to the extent possible. Mortgages will be reduced to reflect their value in the open market. Two forms of transitional assistance may also be provided for individual properties: rehabilitation grants and short-term, project-based rental assistance.

A large number of insured, assisted properties are currently functioning well and will find it easy to attract renters, making the transition with a minimum of difficulty. Properties that have "played by the rules"--provided efficient management and

quality buildings--have the characteristics that will allow them to retain current tenants and attract new ones. Many of the current residents will stay in these properties, even after the removal of project-based assistance, because they are happy with the quality of their housing and desire continuity. Assisted residents living in properties of poor quality, however, deserve the option of seeking a better deal somewhere else. Tenant-based assistance also has the advantage of bolstering income-mixing by granting low-income recipients some mobility.

Transitional assistance will help minimize the disruption to neighborhoods, tenants, property managers and owners. Other proposals to restructure the multifamily insurance portfolio do not include these forms of transitional assistance. These proposals would have a sudden and drastic impact.

It is also important that MTM be implemented as quickly as possible. Left unaddressed, existing physical problems will worsen. Even without the Administration's proposal, there is considerable skepticism in the market that project-based assistance will continue. As a result, we are concerned that disinvestment is already taking place. The situation is analogous to the savings and loan crisis. We have the choice of addressing the problems now and minimizing our costs or trying to work around them as we go and ultimately facing much greater costs. You will not find it hard to guess which of these options we favor.

Best regards,



Robert E. Litan
Associate Director for
General Government and
Finance