Roundtable on HUD Multifamily Issues

Senate Subcommittee on Housing Opportunity and Community Development
July 14, 1995

I. Introduction by John K. McIlwain, President of National Housing Conference and roundtable moderator

II. Welcoming remarks by Chris Lord, Staff Director of the Subcommittee on Housing Opportunity and Community Development

III. Remarks by Helen Dunlap, Deputy Assistant Secretary for Multifamily Housing Programs, U.S. Department of Housing and Urban Development

IV. Background presentation by David Smith, President of Recapitalization Advisors, Inc., Boston MA

V. Discussion of the following issues:

  a) Whether older assisted housing and newer assisted housing should be treated differently;
  b) Assessment of the capital needs of the older assisted stock;
  c) Assessment of the capital needs of the rest of the portfolio;
  d) Special considerations related to state and local bond-financed properties without FHA insurance;
  e) Special considerations related to housing for the elderly; and
  f) Special considerations related to FHA-insured but unsubsidized properties.

VI. Assessment of the current marketplace

VII. Assessment of the urgency/lack thereof to take action on debt restructuring

VIII. Utility of debt restructuring to achieve lower rents

  a) Consideration of transaction costs for HUD and its partners
  b) Consideration of debt restructuring vis-a-vis CBO cost estimates/deficit implications
  c) Concerns about capacity of HUD to handle transactions
  d) Tax consequences
  e) Consideration of effects on residents, properties and neighborhoods

IX. Discussion of project-based versus household-based assistance

X. Renewal of expiring Section 8 contracts

  a) How best to set rent levels (implications of market-based versus budget-based approaches)
  b) How to set rent levels where operating costs exceed true market rents
  c) How to set rent levels where true market rents exceed HUD "fair market rents"
  d) How to set rent levels where Section 236/LMSA property rents are below true market rents

XI. Effect of reducing term of assistance on lenders, owners and residents

XII. How to achieve discretionary savings

a) Through increased tenant contribution?
b) Through increasing average income of residents?
c) Through lowering rent standard?
d) Through reform or elimination of annual adjustment factor?
e) Through better property operations, thereby reducing operating costs?
f) Through replacement of higher-cost project-based assistance with lower-cost vouchers?
g) Reducing number of subsidized units?
h) Reducing rate of return to owners?

XIII. FHA Insurance: Debt Restructuring

a) Determining the appropriate level of risk
b) Role of FHA insurance going forward
c) Who will do the work?
    1) "Reflector sales"
    2) Joint ventures
    3) Hiring and training additional HUD staff
    4) Federal Housing Corporation

XIV. Dealing with troubled real estate

XV. Tax implications

a) Tax status of current owners
b) Tax effects of HUD proposal and alternatives
c) Tax solutions to problems posed by HUD proposal and alternatives
d) Exit tax relief
f) Tax credits for recapitalization

XVI. Alternatives

a) Renewals without defaults (see 1994 Senate housing authorization bill)
b) Voluntary incentives for actors without HUD involvement
c) Resolution entity with fixed budget and mission to serve low income individuals and families, preserve affordable housing and minimize costs/losses to the federal government
d) Other options

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The United Voice for Housing

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List of Attendees

Emily Achtenberg	Housing Consultant
Robert Adams	National Low Income Housing Coalition
Victor Bach	Community Service Society of New York
Valerie Baldwin	Subcommittee on Housing & Community Opportunity
Richard Baron	McCormack, Baron & Associates
Michael Bodaken	National Housing Trust
John Bohm	National Assisted Housing Management Association
Anne E. Canfield	McClure, Gerard & Neuenschwander, Inc.
Carl A. S. Coan, Jr.	Coan & Lyons
Bruce Davie	U.S. Department of the Treasury
Patrick Dober	Multifamily Housing Council
Robert Dodge	National Performance Review
Cushing N. Dolbeare	Housing Consultant
Wendy Dolber	Standard & Poor's
The Honorable Helen Dunlap	**U.S. Department of Housing and Urban Development**
Kathleen Dunn	The Community Preservation Corporation
Kevin East	U. S. Department of Housing and Urban Development
Melody Fennel	Senate Committee on Banking, Housing and Urban Affairs
Wesley E. Finch	The Finch Group, Inc.
Christine Fishkin	U.S. General Accounting Office
Clara Fox	New York Housing Conference
Alan M. Gittelson	E&Y Kenneth Leventhal Real Estate Group

Jim Gould	Hooper Hooper Owen & Gould
Jim Grow	National Housing Law Project
George R. Guscott	Long Bay Management and Development Company
Rick Hale	U.S. General Accounting Office
Bennett L. Hecht	National Center for Tenant Ownership
Karen V. Hill	Yonkers Fair Housing Implementation Office
David Hill	National Association of Home Builders
Gerard Holder	American Association of Homes & Services for the Aging
Jonathan Kamarck	Senate Committee on Housing, Banking, and Urban Affairs
Helen R. Kanovsky	AFL/CIO Housing Investment Trust
Lamar Kelly, Jr.	KFS, Ltd.
The Honorable John F. Kerry	**Ranking Minority Member Subcommittee on Housing Opportunity and Community Development, U.S. Senate**
Cheh Kim	Subcommittee on Housing Opportunity and Community Development
David M. Koss	National Housing Conference
Henry D. Lanier	Lehman Brothers
Warren Lasko	Mortgage Bankers Association
Harold Levy	Brownstein Zeidman and Lore, A Professional Corporation
Herbert J. Levy	National Association of Housing Cooperatives
Nancy Libson	House Subcommittee on Housing & Community Opportunity
Anne H. Lindgren	Housing Consultant
Robert Litan	Office of Management and Budget
Chris Lord	Subcommittee on Housing Opportunity and Community Development
Kenneth G.Lore	Brownstein Zeidman and Lore, A Professional Corporation
The Honorable Connie Mack	**Chairman, Subcommittee on Housing Opportunity and Community Development, U.S. Senate**
Marvin Markus	PaineWebber Incorporated
Dan Martinson	E&Y Kenneth Leventhal Real Estate Group

John T. McEvoy	National Council of State Housing Agencies
John K. McIlwain	Powell, Goldstein, Frazer & Murphy
Marilyn Melkonian	Telesis Corporation
Felice Michetti	Grenadier Realty Corp.
Jonathan Miller	Office of the Honorable Joseph P. Kennedy, II
Denise Muha	National Leased Housing Association
John C. Murphy	Association of Local Housing Finance Agencies
Christine M.J. Oliver	Chicago Dwellings Association
Carla Pedone	Congressional Budget Office
Allan Pintner	Associated Estates Realty Corporation
Don Redfoot	American Association of Retired Persons
Robert J. Reid	National Housing Conference
Carl Riedy	Legg Mason Wood Walker
Celia Roady	Morgan, Lewis, & Bockius
William N. Rumpf	California Housing Partnership
Linda Schakel	U.S. Department of the Treasury
James H. Schuyler	The Schuyler Company
Martin C. Schwartzberg	National Foundation for Affordable Housing Solutions
Wally Scruggs	Reznick, Fedder & Silverman
Kathleen Sheehan	Mintz, Levin, Cohen, Ferris, Glovsky, & Popeo
Marvin Siflinger	Housing Partners, Inc.
Ina Singer	U. S. Department of Housing and Urban Development
David A. Smith	Recapitalization Advisors, Inc.
Johrita Solari	National Assisted Housing Management Association
Rikki Spears	National Housing Conference
Dmitri Stockton	GE Capital Commercial Real Estate
Al Sullivan	HUD
Barbara Thompson	National Council of State Housing Agencies
Kurt Van Kuller	Merrill Lynch

Joseph M. Ventrone	Subcommittee on Housing & Community Opportunity
Gary Weaver	National Association of Realtors
Paul N. Weech	Senate Committee on Banking, Housing and Urban Affairs
Jim Wells	U.S. General Accounting Office
Charles S. Wilkins, Jr.	NHP Incorporated

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, <u>any</u> [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.

• 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.

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20410-0001

- old vs new grps.

FAX TRANSMISSION

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To: Molly Brostrom FROM: Amy Liu

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COMMENTS: Attached you will find:

1. Response to Domber for Sec's signature (not for distribution)
2. HUD analysis of Bond's S.8 Contract Renewals Amendment
3. Basic tutorial on mk-to-mkt.
4. Secy's speech on issue before the Nat'l Multi-Housing Council
5. Draft editorial on mk-to-mkt
6. Response to Senate's S.8 proposal.

I know this is alot to digest. Please call if you have any questions.

Date

Matthew J. Domber
1700 McMullen-Booth Road, #C-3
Clearwater, Florida 34619

Dear Mr. Domber:

Thank you for your thoughtful letter regarding the Administration's initiative to reform Section 8 project-based assistance. From your description, Fairmont Arbors appears to represent the best of our country's housing assistance programs.

On May 26, the Department of Housing and Urban Development (HUD) put forward an historic initiative to reform Section 8 project-based assistance. The initiative -- known as "Mark to Market" -- would directly affect about 8,000 - 9,000 properties which both receive Section 8 project-based assistance and have mortgages insured by the Federal Housing Administration (FHA). The vast majority of the residents of these properties are low income, and a substantial percentage are elderly. How we manage the transition of this portfolio going forward has critical longterm implications for the federal government -- and for millions of residents in hundreds of communities.

Your letter expresses concern that the Mark-to-Market initiative will trigger widespread defaults, lead to financial and tax consequences for Section 8 property owners and disrupt the lives of tenants -- including senior citizens and their families. Let me try to answer your concerns as best as I can.

Under the Administration's initiative:

Section 8 project-based assistance contracts between HUD and the project owner will not be renewed as they expire.

Owners will be free to rent their units for whatever the marketplace will bear. In the case of many Section 8 New Construction projects, this would generally mean a reduction in the rents.

Residents will receive housing certificates that they could use to remain in their current units or move to other housing.

For properties that would not be financially viable without federal project-based subsidies, HUD will assist in writing down the property's debt to a level that can be supported by market rents. The presence of FHA mortgage insurance on these properties provides us with the vehicle to help in this restructuring.

Ailing properties will undergo rehabilitation, where economically feasible.

HUD's preferred approach is to restructure properties' financing and provide for rehabilitation before Section contracts expire and defaults occur. This would make it easier for good owners to remain in place and, from the taxpayers' standpoint, would protect against property disinvestment as the Section 8 program unwinds. I will explain this option for proactive resolution of the Section 8 portfolio further in this letter. But first, I wanted to explain why we have put forth this initiative. It has been developed in response to two overriding realities.

First, neither the Administration nor Congress can afford to continue funding for Section 8 project-based contracts at the current subsidy levels. A large wave of Section 8 contracts expires over the next five years, beginning with contracts on 140,000 units in FY 1996. The Department estimates that the cost just to renew the contracts expiring in FY 1996 would be more than $4 billion, and the pricetag rises sharply to $14 billion by FY 1998. We can't renew Section 8 contracts indefinitely at a time when everyone agrees we must reduce the federal deficit and move toward a balanced budget.

Second, longstanding operational and structural flaws in the Section 8 project-based assistance program have reached critical proportions. HUD is providing subsidies at above-market levels to as many as 3,000 Section 8 properties. Some apartments rent for twice as much as non-subsidized units down the street. This not only drains scarce federal housing resources, it also seriously undermines public support for assisted housing programs across the board. Another large group of Section 8 properties is in distressed physical condition. No matter how badly these buildings deteriorate, however, most tenants can't move because they would lose their rental assistance. They are effectively trapped.

HUD Secretary Henry Cisneros summed up the reality facing Section 8 project-based assistance in a speech before the National Multi Housing Council on September 19. In that speech, the Secretary said:

> "We may differ on the exact approach that should be taken, but -- in the real world of current budgetary constraints -- Mark-to-Market is inevitable. Let me repeat, Mark-to-Market in some form is inevitable. The question is: Do we opt for an orderly transition to a market environment for assisted housing -- as I have outlined here -- or do we walk off the budgetary cliff as more and more Section 8 contracts come up for renewal over the next few years. One thing is clear. The current practice must change. There is no support -- none -- for the oversubsidization of affordable housing."

Since the Mark-to-Market initiative was first introducted, questions have been raised about its impact on owners, properties, tenants and communities. Because the concept is new to many in the Section 8 community, misinformation has sometimes resulted.

For example, it is not true that all project-based assistance would automatically be terminated, as some have represented. You raise a concern that it is difficult to apply market rents to a property when there is, effectively, no surrounding market. This is one reason why the Administration's Mark-to-Market initiative gives localities the flexibility to continue to provide project-based assistance at their option, for however long they choose, where they find it appropriate within the context of their local housing strategy.

There is also a great deal of concern that good owners risk losing control of their properties and have a lot to fear from this implementation plan. In fact, most good owners are not likely to be displaced if the Administration's preferred approach -- proactive resolution before expirations and defaults -- prevails.

Some have charged that HUD plans to use a "one size fits all" rigid process to implement Mark-to-Market. This is also untrue. The Administration's initiative provides many more options for all parties involved in Mark-to-Market than would otherwise be available. For example, the entities working with HUD to proactively resolve the portfolio would have substantial flexibility to respond to each mortgage/property's unique situation. HUD does not have this capacity.

Your letter expresses the concern that tenants, particularly the elderly, will be displaced. Because of the specialized nature of their housing and circumstances, elderly residents and those with disabilities may find it difficult to find suitable alternatives if forced to move from their current apartments. This could become a problem if the new market rents in their units are higher than the levels that would normally be supported by housing certificates. Our proposal would protect these residents against such circumstances by ensuring that their certificates cover the cost of new rent -- whatever its level -- so long as it passes a "rent reasonableness" test for comparable unassisted units in the area.

As for non-elderly tenants, the Department has looked carefully at the potential for displacement, and we have found that:

the vast majority of housing that converts to a market basis under the Mark-to-Market initiative would remain part of the affordable housing stock and would continue to be available to residents currently residing in these same project-based units.

there will be some displacement when run-down housing leaves the stock. HUD estimates that approximately 65,000 units will leave the stock -- but the majority of this attrition will occur with or without Mark-to-Market. In fact, this is happening now as the Department pursues aggressive enforcement against owners who are not meeting their contractual obligations.

Over time, about 30,000 households could be displaced because rents in their properties rise above the levels supported by their tenant-based certificates. In arriving at this estimate, HUD is assuming that tenants could absorb a rent burden of up to 40% of income, but that rent burdens greater than 40% may cause displacement.

Given the reality of budgetary constraints confronting this country, it is important to resolve the future of Section 8 project-based assistance as soon as possible. The private market is starting 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.

Finally, I want to let you know that HUD is aware of the tax implications of Mark-to-Market on owners and has initiated discussions about how to deal with these issues. The Department is working jointly with the Treasury Department, the Office of Management and Budget and members of Congress on this matter.

Thank you again for your thoughtful letter. I have transmitted your suggestions for modifying the Mark-to-Market initiative to officials at HUD.

Sincerely,

Harold Ickes
Deputy Chief of Staff
Office of the President

Budget Implications of Bond's Renewals Amendment (Sec. 214)

This is going from bad to worse. Essentially, this makes renewals consistent with Kohashi's MTM demonstration, specifically guaranteeing owners a profit. The scoring implications are:

1. Unlike the Demonstration provision (Sec. 213), this provision produces no new direct costs. This is because renewals are subject to appropriations -- all costs are covered by the renewal amounts specifically funded elsewhere in the bill. The provision actually attempts to neutralize direct cost scoring by making incentives for conversion to tenant-basing subject to appropriations.

2. In the near term (at least through most of FY 1996), the cost of renewals will either stay the same or increase. Pending implementation of a "budget-based" system for determining renewal rates, the current rates remain in effect -- eliminating any savings anticipated from conversion to vouchers. When a "budget-based" system is implemented, the net effect will be increased costs. Owners of many older properties may be able to argue for higher rents, especially given that maintenance needs (significant for this subset) are incorporated into the rent calculation. There may be some savings from eliminating current rents over 120 percent of FMR and by using the budget-basing to reduce rates for overly subsidized projects. Because these would apply almost exclusively to newer properties (the minority of renewals in the near-term) savings in this time period would be minimal. More importantly, HUD will at a disadvantage in implementing "budget-basing." Poorly paid, over-worked HUD employees will go up against highly paid specialists who have the best information on the affected properties.

3. The amendment, if applied to the FHA insurance baseline, would not aid us in adjusting the mandatory baseline for our proposed reductions to rental subsidies. Simply put, our efforts to correct both the subsidy and insurance baselines (and to have CBO do the same) could continue; but until there is appropriations action to reduce discretionary subsidies, those efforts would not show higher claims costs against which to estimate savings from Mark-to-Market.

4. Conversion to tenant-basing still rests on consent of the owner (and now, consultation with tenants). This is a lot like preservation: owners will want to convert where they can make more money by renting to unsubsidized tenants. Universally, this would be in attractive projects with low current subsidies, leading to higher subsidy costs.

Reforming Section 8 Project-Based Assistance
The Administration's Mark-to-Market Initiative

On May 26, the Department of Housing and Urban Development (HUD) put forward an historic initiative to reform Section 8 project-based assistance.

The initiative -- known as "Mark-to-Market" -- would directly affect 8,000-9,000 properties. These properties both receive Section 8 project-based assistance and have mortgages insured by the Federal Housing Administration (FHA).

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

The goal of Mark-to-Market is often expressed in financial terms -- saving budget dollars. But the scope is really far broader. Mark-to-Market provides a unique opportunity to rebuild our distressed neighborhoods by allowing market forces to work there and by giving low income households far more choice over where they live. It will enable us to replace a wasteful, rigid and bureaucratic system of housing assistance with a modern, market-driven system that truly serves the people who live there.

Under the Mark-to-Market initiative:

**Section 8 assistance contracts between HUD and the project owner will not be renewed as they expire.

**Owners will be free to rent their units for whatever the marketplace will bear. In the case of newer Section 8 projects, this would generally mean a reduction in the rents. For older projects, this would generally mean the same rents or an increase up to market levels.

**Residents will receive housing certificates that they could use to remain in their current units or move to other housing. Special protections would ensure most elderly and disabled residents could remain in their present units if they so choose.

**For properties that would not be financially viable without federal project-based subsidies, HUD will assist in writing down the property's debt to a level that can be supported by market rents. The presence of mortgage insurance on these properties provides us with the vehicle to help in this restructuring.

**Ailing properties will undergo rehabilitation, where economically feasible.

**In some cases, it may be appropriate to sell or transfer the property to a non-profit or local government organization. These entities, with a stake in the needs of the community, may be able to use HOME or other funds for rehabilitation, as necessary.

**HUD's preferred approach is to restructure properties' financing and provide for rehabilitation before contracts expire and defaults occur. This would make it easier for good owners to remain in place and would protect against property disinvestment as the Section 8 program unwinds.

The Mark-to-Market initiative has been developed in response to two overriding realities:

**Neither the Administration nor Congress supports continued funding for Section 8 project-based contracts at the current subsidy levels. One clear indicator of this mood is the recent legislation passed by Congress and signed by the President, rescinding $2 billion in funds already authorized for Section 8. A large wave of Section 8 contracts expires over the next five years, beginning with contracts on 140,000 units in FY 1996. The Department estimates that the cost just to renew the contracts expiring in FY 1996 would be about $5 billion, and the pricetag rises sharply to $14 billion by FY 1998. If we continue with the status quo, we will spend about $222 billion in present value dollars over the next 25 years on Section 8 renewals alone. Indeed, soon nobody will be talking about closing down HUD. Section 8 renewals will have swallowed the entire Department!

**Longstanding operational and structural flaws in the Section 8 project based assistance program have reached critical proportions. Our analysis reveals that HUD is providing subsidies above market levels to as many as 3,000 Section 8 properties. Some apartments rent for twice as much as non-subsidized units down the street. This not only drains scarce federal housing resources. It also seriously undermines public support for assisted housing programs across the board. But oversubsidization is not the only problem. Another large group of Section 8 properties is undersubsidized and in distressed condition. No matter how badly these buildings deteriorate, however, most tenants can't move because they would lose their rental assistance. Structurally, we have built an elaborate housing delivery system that is not sufficiently responsive to tenants.

Options for Implementing Mark-to-Market

HUD is considering several options for ensuring a smooth transition to market for Section 8 properties. The preferred approach is to help properties transition to a market basis voluntarily *before* Section 8 contracts expire. HUD would do so by entering into public-private joint ventures with entities that are experienced in restructuring real estate and also sensitive to public policy goals. The joint ventures would operate under carefully established HUD guidelines and would help properties make the transition to market on a property-by-property basis. HUD currently lacks the capacity to respond to the needs of each property individually. The Department is seeking the authority to create pilots to demonstrate the advantages of proactive resolutions.

Myths And Realities about Mark-to-Market:

Myth: All project-based assistance would be terminated. There is widespread belief that HUD would mandate an end to all project based assistance for Section 8 properties. This is not true. The initiative gives localities the option to use the housing certificate funds we provide -- as well as other funds they may have available -- to continue providing project-based assistance to Section 8 properties for however long they choose.

Myth: Thousands of elderly households will be disrupted. Because of the specialized nature of their housing and circumstances, elderly residents and those with disabilities could have particular difficulty locating suitable alternatives if forced to move from their current apartments. This could become a problem if the new market rents in their units are higher than the levels that would normally be supported by housing certificates. Our proposal would protect these residents by ensuring that their certificates cover the new rent, whatever its level, so long as it passes a "rent reasonableness" test for comparable unassisted units in the area.

Myth: The transition to market of the Section 8 portfolio will lead to massive displacement. Some groups are circulating figures purporting to show that more than 170,000 households will be displaced by Mark-to-Market. The Department has looked carefully at the potential for displacement - and we have found that these claims are greatly exaggerated. They don't account for the extra support available to elderly and disabled households. They erroneously assume that any rent increase, even one dollar, above the Fair Market Rent will cause displacement.

HUD's analysis of the potential for displacement shows:

**The vast majority of housing that converts to a market basis under the Mark-to-Market initiative would remain part of the affordable housing stock and would continue to be available to residents currently residing in these same project-based units.

**There will be some displacement when obsolete housing leaves the stock. We estimate that approximately 65,000 units will leave the stock - but that the majority of this attrition will occur with or without Mark-to-Market. In fact, this is happening now as the Department pursues aggressive enforcement against owners who are not meeting their contractual obligations.

**About 30,000 households could be displaced because rents in their properties rise above the levels supported by their tenant-based certificates. In arriving at this estimate, we assume that tenants could absorb a rent burden of up to 40% of income, but that rent burdens greater than 40% may cause displacement.

Why Delay Is Not An Option

Because Mark-to-Market represents change, there is an understandable tendency to focus on its potential for disruption. But the initiative also offers significant benefits. For the first time residents will have the option of moving and taking their subsidy assistance with them. Older properties in need of repair will finally be able to be upgraded. Residents will have opportunities to purchase their projects as cooperatives where feasible or to apply their new tenant-based housing certificates toward homeownership. As the old housing system converts, we have a once-in-a-generation chance to equip these buildings with computer learning centers, job training and microenterprise centers, and other services that have been proven to work in helping low income residents make the transition to self-sufficiency.

Some are uring us to take more time to sort out all the answers before transitioning this complex portfolio to a market-based system. Such advice may seem superficially rational -- and even prudent. Unfortunately, in the real world, we do not have the luxury to delay implementing a transition plan -- not even for one year. The private markets have already begun to react as owners, investors and lenders realize that project based subsidies will not continue indefinitely. The risk of inaction is that owners will disinvest and that physical deterioration of older projects will accelerate. Against this backdrop, timely implementation of Mark-to-Market is essential.

National Multi Housing Council
Washington, D.C.
September 19, 1995
Secretary Henry G. Cisneros

Thank you, Austin (Fitts), for that kind introduction and for your visionary work in developing electronic villages in assisted housing in some of our most distressed communities.

I recently had an opportunity to visit Edgewood Properties here in Washington, D.C., where you (Austin) have set up a computer lab and learning center for children and adults. This facility gives residents the educational opportunities and jobs they need to build self-sufficient lives. Edgewood is an outstanding example of what assisted housing communities can be and I salute you.

And I want to thank the National Multi Housing Council, its members and staff for helping HUD in the fight to increase funding for the multifamily credit subsidy. The House Appropriations bill provided only $69 million for the next fiscal year, but the Senate Appropriations Committee version raised the funding level to $100 million after hearing from a number of concerned groups, most prominently your organization and its members. Congratulations. Your advocacy on this issue is appreciated.

Just the other day we were faced with a new challenge. Republican tax proposals include a sunset of the low-income housing tax credit at the end of 1997. The credit, which was just made permanent in 1993, currently accounts for one out of every five new apartments built in our country and virtually every one of the new apartments built for low-income renters. Although it is not a HUD program, the credit is integral to the effort to provide adequate housing for low- and moderate-income people. A sunset that will force Congress to come up with new revenue to extend the credit into the future will truly jeopardize it. I hope that you will express your feelings to Congress about this action.

The challenges we have faced in Congress on FHA's multifamily credit subsidy and on the low-income housing tax credit are part of a broader challenge to HUD's mission.

(These remarks were prepared for delivery by Secretary Henry G. Cisneros, whose actual remarks may have departed from this text.)

One group of freshmen Republican House members, joined by some Republican senators, has called for HUD's outright elimination. The Republican leadership in Congress -- while not going as far as the complete elimination of HUD -- has supported sharp cuts in HUD's budget. The House cut HUD's funding 27 percent -- from $26.1 billion in the current fiscal year to $19.1 billion in fiscal 1996. The full Senate will be considering our appropriations bill next week, and we are facing significant cuts on that side of the Hill as well.

We knew, going into this Congress, that we would face some very tough sledding. We also knew that at least part of the reason we were in for a tough time was the general feeling of the American people and Congress that HUD wasn't doing its job well.

The department has had problems. There is no getting around that. In the 1980s, HUD was racked by scandal. Over the decades, HUD spawned labyrinthine rules, regulations and procedures. HUD incubated a management culture which valued paperwork over performance; process over progress. Frankly, when I was mayor of San Antonio, I despaired at the thought of working with HUD, as much as we needed its resources.

Going into this year, we knew that if HUD was to survive -- and more importantly, if HUD was to continue to carry out its mission, which is helping communities and people lift themselves -- the Department would have to change the way it does business, and change very dramatically.

So we proposed a truly far-reaching reinvention plan.

- We proposed to consolidate 60 major, separately funded programs into three, broad, flexible funds for housing assistance, affordable housing development and community economic development.

- We proposed a radical transformation in public housing. Instead of subsidizing buildings and local public housing bureaucracies, we proposed to shift to direct assistance to residents, who would receive housing vouchers and certificates which they could use toward rent in public housing developments or in privately owned buildings.

- And, finally, we proposed to transform the Federal Housing Administration into a government-owned Federal Housing Corporation, which would operate more like a private mortgage-insurance company and work much more effectively with the private market.

There are two common threads through all these proposals: choice and market discipline.

With program consolidation, we are saying that our primary role is to support local initiative. We will no longer tell local communities: You can build elderly housing, or disabled housing -- or you can build a single room occupancy facility for the homeless -- because that's what we've allocated money for. We'll say: Here are the resources, based on your need. **You decide** how to deploy them. We're saying: It's your choice.

But we're also saying to communities that we want to see results. We want communities to set goals for affordable housing; increased homeownership; and jobs. Under our reinvention plan, communities that meet and surpass these goals would be eligible for additional funds. Communities that fail to meet their goals would not get extra money. Our program consolidation proposal injects market incentives and discipline into federal funding.

In public housing, we have proposed to move to a system of direct assistance to residents that empowers them to make the same kinds of choices other people make about where they live. If a public housing development is well-run and safe, residents will stay there. If it is poorly managed and dangerous, they will leave. Public housing managers will have to compete for their business. Choice for residents; market discipline for housing managers.

Our proposals to transform FHA are driven by market imperatives. FHA is a Fortune 100-size insurance company with a $380 billion portfolio today. But its current procedures are cumbersome and its ability to adjust to changing market conditions is constricted by statutes, rules and regulations. FHA has made a tremendous contribution in communities nationwide, opening the doors of homeownership to 23 million Americans without costing taxpayers a dime. But after 61 years, it needs an overhaul. The new Federal Housing Corporation which we have proposed would operate more efficiently and effectively in today's market, while still pursuing its singular public mission -- ensuring that rental housing and homeownership remains within the reach of working families.

Part of our reinvention plan for FHA is our "Mark-to-Market" proposal for Federally subsidized, privately owned rental housing. Choice for residents and market incentives for landlords are the central themes of Mark-to-Market.

Two overriding realities are driving the Mark-to-Market strategy. First, if we continue business as usual, the cost of Section 8 renewals will swallow HUD's budget. Next year, fiscal year 1996, 140,000 Section 8 contracts will expire. The cost to renew those contracts would be more than $4 billion, with the price tag rising sharply to $14 billion by 1998. We can't renew Section 8 contracts indefinitely at a time when everyone agrees we must reduce the federal deficit and move toward a balanced budget.

Second, the current system denies choice to renters and prevents the market from imposing its discipline on the cost and quality of the rental stock. A survey of properties found that HUD provides subsidies above market levels to as many as 3,000 Section 8 properties. Some apartments rent for twice as much as non-subsidized units down the street. We simply can't expect the federal government to continue subsidizing rents that are excessive compared to rents in unsubsidized housing.

In other cases, the buildings deteriorate, yet the tenants can't move because they would lose their rental assistance. Current policy denies those tenants the right to choose where they want to live. They should be able to move. We must not lock people into substandard housing.

You, as some of the largest multi-family housing owners, developers and financiers, know the importance of surviving in the marketplace. We want to inject the vigor of the market into our assisted-housing inventory.

Mark-to-Market addresses these problems by tying rental assistance to market rates, allowing renters the option of choosing the best apartment they can find.

Mark-to-Market does not mean an end to all project-based assistance for Section 8 properties, as some have charged. That would go against the grain of reinvention, our commitment to give local areas the flexibility to determine local solutions to local problems. The Mark-to-Market initiative gives localities the flexibility to provide project-based aid at their own option, for however long they choose, where they find it appropriate within the context of their local housing strategy.

Some have expressed their concern to us about the transition to a market basis for Section 8 properties, and HUD is considering several options to ensure that the changes go smoothly.

Our preferred approach is to help properties transition to a market basis voluntarily before Section 8 contracts expire. This would make it easier for good owners to remain in place and would protect against property disinvestment.

We are aware of the tax implications of debt restructuring and its impact on cancellation of indebtedness income. We're working with the Treasury Department, the Office of Management and Budget and members of Congress and the stakeholders on the best way to deal with it.

We may differ on the exact approach that should be taken, but -- in the real world of current budgetary constraints -- Mark-to-Market is inevitable. Let me repeat, Mark-to-Market in some form is inevitable. The question is: Do we opt for an orderly transition to a market environment for assisted housing -- as I have outlined here -- or do we walk off the budgetary cliff as more and more Section 8 contracts come up for renewal over the next few years.

One thing is clear. The current practice must change. There is no support -- none -- for the oversubsidization of affordable housing.

In Congress, the House has provided us with an opportunity to pursue a limited Mark-to-Market approach, consistent with many of our recommendations. The Senate's approach, however, contains significant costs that our Mark-to-Market plan attempts to curb over time. The Senate approach also fails to create the kind of market incentives that we're trying to reinstate in our multi-family portfolio.

House and Senate negotiators will soon begin discussing the Mark-to-Market initiative when they meet in conference on the HUD appropriations bill. We look forward to the upcoming conference and hope that Congress will deal directly and forcefully with these issues in order to provide guidance to owners, managers and residents of these properties and to the capital markets, which are awaiting a resolution of this issue.

Our Mark-to-Market initiative incorporates key elements of HUD's reinvention -- choice and market discipline -- and it responds to the American people's insistence that we break with old ways of doing business that have not served communities, residents or taxpayers. We are building a new HUD which will more effectively carry out its central mission of helping to create communities of opportunity where people can lift themselves. The new HUD will be customer-oriented and performance-driven.

Our Mark-to-Market plan paves the way for the new HUD by addressing a major problem of the old HUD -- oversubsidization and the lack of market incentives. When we look to the future of assisted housing, we see exciting efforts like the electronic villages of Austin Fitts, where we try to create an environment that gives residents choice and educational and economic opportunity. You will play an integral part in building these environments and I look forward to creating this future with you.

Thank you.

DRAFT EDITORIAL
Mark-to-Market--MF Portfolio Restructuring

June 26, 1995 [961 words]

Bridge Over Troubled Waters

Located in hundreds of communities across the United States--whether dotting rural byways or squeezed into crowded urban neighborhoods--more than 9,000 apartment buildings or complexes provide affordable homes to nearly one million households. The vast majority of residents are low-income and well over one-third are elderly Americans.

Built over the last 20 years, these rental units are affordable because the properties are privately owned and the owners receive federal housing assistance payments to supplement rents through a program known as Section 8, operated by the U.S. Department of Housing and Urban Development (HUD). These properties are also insured by the Federal Housing Administration (FHA) and represent approximately $28 billion, accounting for the bulk (4/5) of HUD's FHA-insured rental housing portfolio.

Unfortunately, over time, the economics of providing Section 8 rental assistance on these properties have become impossible. Certain newer properties receive more federal assistance than necessary to maintain them as decent affordable housing--draining scarce tax dollars. It's not unusual to find rents at Section 8 properties far above local market rents for comparable apartments. Other, older developments are under-subsidized and have fallen into serious disrepair, causing problems for residents and neighborhoods alike. Meanwhile, because the subsidy is attached to the property, residents are trapped. If they wish to escape their substandard apartments in pursuit of better housing, they risk losing their rental assistance. Finally, the absence of market incentives has resulted in an outmoded federal housing assistance delivery system--indifferent to market forces and subject to a myriad of obsolete or conflicting rules and regulations.

In short, the system that created these homes is broken and its cost, paid by taxpayers, continues to spiral out of control.

Making matters worse, anyone familiar with the world of affordable rental housing knows that a menacing wave looms on the horizon, building in volume and intensity. Beginning in Fiscal Year 1996, a wave of Section 8 project-based assistance contracts with private owners will begin to expire. Renewing these contracts carries a $5 billion pricetag the first year; cost projections to underwrite future years make that look like a bargain. The FHA has been working diligently over the past two years to keep this swelling tide from crashing at its doorstep with the force of a tidal wave.

The surge of expirations presents not only a pressing budgetary challenge, but an opportunity to rethink and reconfigure a flawed delivery system for housing assistance to lower income Americans. The federal government has often averted claims against the FHA's insurance fund by applying subsidies and a regulatory structure that has virtually masked the true market value of the properties. The result of this bandaid approach is a chronic structural problem that we can no longer afford to ignore. Two alternatives are obvious: we can either maintain the status-quo, which means renewing every contract--at exorbitant taxpayer expense to support a dysfunctional system--or we can shut down assisted housing and disrupt hundreds of thousands of lives.

There is a third and preferable, if more difficult, solution to this problem. HUD has proposed to Congress an approach called "mark-to-market" which attempts to deal responsibly with the wave of expiring Section 8 contracts on properties with FHA-insured mortgages. Instead of renewing contracts upon their expiration, properties will be refinanced allowing owners to set or "mark" their rents to whatever the local market will bear. Restructuring the portfolio so that it will be market-driven will employ a variety of approaches tailored to particular properties. But the goal is constant: to de-link the subsidy from the property. By separating the subsidy from the property, the underlying value of the real estate will be subject to private market forces. For example, this may result in decisions to demolish properties that are no longer useful as affordable housing.

Under the reform proposal, residents will be protected. Housing certificates would be made available to all affected residents to apply toward rents elsewhere or toward the purchase of a home. Special arrangements would be made for elderly residents and those with disabilities. In all cases, these residents would have true choice about where they live. The housing certificates will give residents more mobility, providing new incentives to owners to maintain a competitive product.

HUD's blueprint for restructuring its FHA-insured rental properties is not some risky experiment, but a tried-and-true idea borrowed from the private sector. The nation's private rental market underwent profound changes in the late 80s and early 90s, following the passage of federal legislation that curtailed real estate tax shelters and the end of inflation-driven profits. Suddenly, owners were forced to compete on the basis of providing better housing and services to residents at a lower cost.

Congress has the opportunity now, with federal housing assistance contracts beginning to expire in the next year, to preserve and enhance an investment already made by the nation's taxpayers. Without a doubt, this is one of the most far-reaching reforms HUD has proposed to date. For Congress, it represents the opportunity to introduce the most fundamental shift in federal housing policy since the early 70s. The careful overhaul of HUD's FHA-insured/assisted rental property portfolio will:

reduce the debt on insured properties to levels that the market can support,
halt and reverse the physical and financial decline of many of these properties,

- terminate the over-subsidization of certain properties, and
- avoid displacement of residents and provide them with choice about where they want to live.

HUD has the plans, the expertise, the will and the capacity to construct a modern, well-tooled bridge over these troubled waters: it just needs the building permit from Capitol Hill to do it. In the process, Congress will be facilitating the transformation of the system that allowed this perilous wave to build momentum in the first place.

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The Senate's Section 8 Renewal Provision Will Be Costly And Bureaucratic And Will NOT Reduce Section 8 Rental Subsidies to Market Levels

On Wednesday, September 27, the U.S. Senate passed legislation that would substantially alter the Section 8 assistance program by shifting to a new *budget-based* system for determining rent subsidy levels. The ostensible purpose of this Senate provision is to "begin to address the high-cost of Section 8 project based assistance." In fact, the Senate provision will do exactly the opposite. Moreover, in passing this bill, the Senate has inexplicably impeded the comprehensive reform of the Section 8 program initiated by the Administration and facilitated in the House appropriations bill.

No Market Discipline. The Senate's approach will not bring Section 8 properties under the discipline of the marketplace. In fact, it moves the program even further away from the goal of market rents and real cost controls.

No Cost Savings. The Senate's approach will not rein in the soaring costs of Section 8 project-based assistance. In fact, it all but guarantees far greater costs for this program. The Senate's budget-based renewal provision effectively gives property owners "veto" power over the method and cost of providing housing assistance for the poor -- at the taxpayers' expense.

No Choice for Tenants. The Senate's approach will keep tenants trapped in their buildings -- no matter how deplorable the conditions -- by keeping their assistance project-based.

More Bureaucracy, Not Less. The Senate's approach will require the creation of more bureaucracy -- not less -- to administer the Nation's Section 8 program.

The Senate proposal would mandate the renewal of expiring Section 8 contracts at a *budget-based* rent level for all projects subsidized under the Section 8 New Construction/Substantial Rehabilitation program. Under such an approach, assistance levels would be based on the "actual and projected costs" of operating the project -- debt service, operating expenses (including reserves and maintenance and rehabilitation), an allowance for operating losses due to vacancies and failure to collect rents, an allowance for return on owner equity not to exceed 6%, and other expenses to be determined.

No Market Discipline. Rather than allow owners to establish rents that can be supported by the marketplace, the Senate's proposal "marks to expenses." Such an approach will not encourage owners to control management fees and other expenses paid to related entities. Instead, it motivates owners to inflate such expenses and to retain high operating costs to avoid cash flow and tax implications. Moreover, the proposal guarantees owners return on equity of up to 6% -- i.e. 6% -- whether the owner is efficient or inefficient, and whether or not the rents bear any resemblance to what the market can bear. As a result, two owners with identical properties in the same market would receive different rent subsidies simply because one is inefficient and the other efficient. Unfortunately, the inefficient owner would receive the higher subsidy under this proposal.

No Cost Savings. The Senate's proposal assumes that budget-based rents will be lower than current rents on about 3,000 Section 8 properties which are presently subsidized at levels above market rents. But there is simply no justification for this view. Budget-based rents may be even more costly because they encourage waste and inefficiency.

No Choice for Residents. The Senate provision would bar tenants from moving out of their units and receiving portable vouchers unless the owner consents to conversion from project-based to tenant based assistance. But what purpose is served by trapping tenants in poorly maintained facilities? The Senate provision anticipates the payment of "incentives" to owners to convert to tenant-based assistance -- at an undetermined cost. Because the Senate proposal would allow owners to make the choice and name their price, the taxpayers will almost surely have to bear the cost of the higher cost alternative.

More Bureaucracy, Not Less. To carry out the provisions of the Senate bill, HUD or its agent would be required to set appropriate rent levels based on expenses on a project-by-project basis. Such new bureaucratic reviews will move these properties further from a market oriented rent structure. Moreover, the Senate renewal proposal introduces an entirely new project by project evaluation by HUD. This evaluation will be expensive and time consuming to implement. The Senate approach directly contradicts consistent efforts by the Administration and HUD to reduce and remove regulations and bureaucratic involvement in these privately owned properties.

Other Problems with the Senate Renewal Provision

The Senate's proposal will result in no adjustment to the baseline. Such an adjustment is needed to recognize the reality that there is no longer the will or the capacity to fund excessive subsidies. The Senate's bill will narrow the legislative options for a longer-term reform of Section 8 next year.

The Senate's proposal would continue FHA insurance on these properties -- and keep the federal government in the troublesome position of providing both insurance and subsidies on these projects.

A Better Approach

On May 26, the Administration put forward a comprehensive initiative to reform Section 8 project-based assistance. The House-passed appropriations bill facilitates this reform by ending excessive project-based rent subsidies.

Under HUD's Section 8 reform initiative:

Section 8 project-based assistance contracts between HUD and project owners would not be renewed as they expire. Owners would mark their rents to market -- that is rent their units for whatever the marketplace will bear.

Residents would receive housing vouchers that they could use to remain in their current units or move to other housing. Special protections would ensure most elderly and disabled residents could remain in their present units if they so choose.

For properties that would not be financially viable without federal project-based subsidies, HUD will assist in a private sector restructuring of the project's debt to a level that can be supported by market rents. The presence of FHA mortgage insurance on these properties provides the vehicle to help in this restructuring by permitting a partial payment of claim.

HUD's preferred approach is to restructure properties' financing and provide for rehabilitation before contracts expire and defaults occur. This would make it easier for good owners to remain in place and would protect against property disinvestment as the Section 8 program unwinds. The Department is seeking authority to carry out pilot demonstrations to evaluate this approach.

Conclusion

The Senate's approach to shift to a budget-based Section 8 subsidy system is no improvement. On the contrary, if this approach prevails:

The Section 8 program will move even further away from the goal of market rents and real cost controls

The costs of the Section 8 program will not be brought under control.

Tenants will not be given more choice over where they live.

The Section 8 program will require more bureaucracy -- not less -- to administer.

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June 12, 1995

THE MYTHS AND COSTS OF MARK-TO-MARKET:

The Department of Housing and Urban Development's Proposal

to Eliminate the Privately-Owned, Assisted Multifamily Portfolio

A. Introduction

The Department of Housing and Urban Development (HUD) has proposed eliminating the current system of project-based assistance, where rental assistance is tied to specific buildings that were built and financed under the assumption that the units would receive rent subsidies for an extended period. As current contracts expire, HUD would replace the project-based system with portable rental assistance certificates that qualified families and individuals could use to meet rent payments in any building in which they choose to live. Beginning in 1996 and continuing for the next nine years, project-based rental assistance contracts for properties in the private, assisted stock will expire at the rate of 80,000 to 130,000 units each year.

For the portion of the privately owned, assisted housing stock that carries Federal Housing Administration (FHA) mortgage insurance, HUD also has proposed a "mark-to-market" process where, as current project-based assistance contracts expire, FHA mortgage insurance would be withdrawn and the mortgages would be sold to private bidders. The FHA multifamily insurance fund would cover losses on the sales, that is, the difference between the bid and the face value of the mortgage. HUD has termed this process "mark-to-market" because they assume the bidding process would accurately pare project debt to market valuation and that the resulting lower debt service requirements would allow rents to be lowered to market levels.

This paper discusses the myths and costs of HUD's "mark-to-market" proposal, which NAHB believes is severely flawed, particularly when coupled with the termination of project-based assistance. HUD is proposing radical change through a highly complex mechanism without adequate provision for transition or consideration of the consequences to all parties involved. The proposal risks considerable and unnecessary displacement of tenants, especially elderly and disabled, many of whom will have difficulty finding decent alternative housing. The proposal also ignores the rights of current owners and would cause them considerable economic harm. In addition, HUD's proposed approach would be more costly than continuing the current system without change.

NAHB fully concurs that modifications should be made in the HUD-assisted portfolio, including a mark-to-market process that adjusts project debt and rents to market levels. HUD's approach, however, is not the appropriate way to proceed.

B. HUD's Current Proposal

The Department's current proposal focuses on privately-owned multifamily properties that have FHA-insured mortgages and that receive Section 8 project-based rental assistance. HUD estimates that there are about 9,000 projects with 900,000 apartments in this category. These properties have mortgages totaling approximately $28 billion.

Under the HUD plan, when the current rental assistance contracts expire, FHA-insured mortgages would be sold without ongoing FHA mortgage insurance. The sales would occur through one of four methods: 1) the sale of the mortgage to the highest bidder; 2) the transfer of the mortgage to a HUD disposition agent who would dispose of the mortgage through sale to the highest bidder, inclusion in a bulk sale, or conveyance to a state or local government; 3) the transfer of FHA's insurance liability for all mortgages to be sold to one or more private entities who would handle the resolution of the portfolio on a property-by-property basis; or, 4) the transfer, prior to default, of individual mortgages likely to default upon the expiration of the Section 8 rental assistance contract, to private entities for resolution.

HUD assumes that the purchasers of the mortgages will base their bids on market rent levels. New rents would be established at levels consistent with the sales price and new debt level. Project-based rental assistance would be provided for a two-year transition period and tenants would receive portable housing certificates at the end of the transition period. Upon completion of the transition period, HUD's role as a mortgage insurer and a provider of rental housing assistance for these projects would end.

C. How Will Tenants Be Affected?

The Department contends that residents in affected properties will be protected through the receipt of tenant-based housing certificates to secure housing of their choice. Also, they maintain that elderly residents and residents with disabilities will be protected by tenant-based certificates with special features.

In reality, as the Department acknowledges, there is no guarantee that Congress will appropriate an annual level of certificates sufficient to cover all residents in units which lose project-based assistance. In fact, as evidenced by the recent FY 1995 rescission legislation and FY 1996 budget resolutions, Congress is very likely to reduce, over time, the overall level of federal rental housing assistance to achieve major savings in the effort to balance the federal budget. It is clear that significant reduction of long-term costs to the federal government from HUD's assisted multifamily portfolio can only be achieved by reducing the number of families and individuals receiving federal rental subsidies.

Therefore, NAHB believes that HUD's disposal program will produce significant levels of resident displacement. Many residents will be forced from their homes before they are prepared to move. Some residents who do not wish to relocate to other areas will be forced to move from their neighborhoods. Tenants who do not receive rental assistance will have to either substantially increase their rent burden, find lower quality rental units, or double up with other families. Some will choose not to form households and, unfortunately, some will become **homeless**. Even if portable housing certificates were provided to all tenants currently in properties in accordance with the Department's proposal, we estimate that more than 170,000 households would be displaced because they could not afford to pay market rents with their certificates or because certain properties will be demolished. If, as expected, budget pressures lead Congress to curtail the availability of portable rental housing certificates, then nearly 400,000 families and individuals, including the elderly and disabled, could be displaced.

D. How Will Owners and Investors in the Properties Be Affected?

The Department maintains that current owners will benefit from having a recapitalized property in a state of good financial and physical health as the property converts to tenant-based assistance.

NAHB believes that HUD's disposal proposal is, in effect, an action that would take these properties from their current owners and investors, selling not only the debt but also transferring the current owners' and investors' equity, future cash flow, resale value, and management and mortgage servicing fees to the purchasers of the mortgages.

These "takings" would occur because the mortgages would be transferred at full face amounts while new market rents would be set at levels that will only support lower debt. The resulting cash flow deficit would permit the purchasers to immediately foreclose and gain control of project equity and other value associated with the properties. Bidders seeking project equity and other value will pay more than lenders or the existing owners seeking to purchase only the debt. The successful purchasers, therefore, will be those who will foreclose on the existing owners and investors. Foreclosure will also trigger adverse tax consequences for the current owners and their investors. Alternatively, the mortgage purchasers could use their leverage to extract equity, cash or both from ownership entities seeking to avoid adverse tax consequences.

Because owners in place have major legal rights and strong practical reasons to successfully restructure the financing of these properties, they are in the position to rework project financing at the lowest cost to the government.

E. Will the Department's Proposal Save the Government Money?

The Department contends that their proposal would save the government money when compared to renewing Section 8 project-based rental assistance contracts.

In fact, according to the Congressional Budget Office (CBO), HUD's proposal would not save the federal government money. CBO recently prepared 25-year costs estimates for both renewals of project-based assistance and the Department's proposal. **The CBO study indicates that HUD's disposal proposal would cost $4 billion more than simply renewing all expiring Section 8 project-based assistance contracts.**

HUD's proposal would produce huge up-front demands on FHA's multifamily insurance fund. Forcing 900,000 multifamily units into new ownership hands in a short four-to-five-year period would sharply depress values of all affected properties. Such forced liquidations would minimize the value of the portfolio and maximize the claims against the $28 billion federal mortgage insurance exposure. The RTC experience, which HUD's disposal proposal closely parallels, utilized bulk sales creating market values so low that the purchasers could make huge profits by simply holding the properties and selling them gradually into a non-disrupted market.

F. What are the Alternatives?

HUD should focus on solutions to principal problems affecting the privately owned HUD-assisted multifamily portfolio rather than simply selling it off and creating even more severe problems. Problems which require attention include:

- financial and physical rehabilitation of viable projects in the portfolio;
- removal of failed properties from the portfolio; and
- reduction of the long-term economic cost for continuing to operate the portfolio.

A number of principles should be observed in addressing these problems:

- The removal of apartments from the affordable housing stock should be minimized;
- Government expenditures should achieve the maximum impact on the target population;
- The effects on tenants should be minimized;
- Protection should be provided for vulnerable tenants (i.e., those tenants, such as the elderly and disabled, who would have difficulty finding alternative housing);
- The economic position of owners and equity and debt investors should be protected (e.g., no adverse tax consequences);
- Protection should be provided for sound properties that are in areas where unassisted operation is impossible;
- There should be a complete and innovative review of restructuring options for the HUD-assisted multifamily portfolio; and
- Project-based rental assistance should be the principal method of providing rental assistance to multifamily properties subjected to modification and housing vouchers should only be used for tenant protection in displacement.

Solutions need to address the central issue of the budget pressures created by renewals of expiring Section 8 project-based rental assistance contracts. NAHB has developed a proposal that deals with this problem, while incorporating the principles outlined above. We would be happy to make copies of this proposal available and discuss our recommendations.

EXECUTIVE OFFICE OF THE PRESIDENT

21-Aug-1995 01:44pm

TO: Molly Brostrom

FROM: Joseph Firschein
Office of Mgmt and Budget, HTF

CC: Francis S. Redburn
CC: Adam Hoffberg
CC: Robert E. Litan
CC: Alan B. Rhinesmith

SUBJECT: Notes on meeting w/ Leon Weiner on MTM

Molly:

Per your request, here are my notes of the meeting that you, Steve Redburn, and I had on August 17, with Leon Weiner (W) and Carl Coan (C) and National Association of Homebuilders staff (Michael McCullough and David Ledford). Although the meeting was not particularly substantive, it was helpful in identifying: (1) W's (and the National Homebuilders Association's) concerns about HUD's proposed Mark-to-Market (MTM) proposal and (2) W's preferred course of action (to delay national tenant-based proposal and take a more limited demo approach).

W's background. W. served on the 1967 Kaiser Commission that reviewed housing policy. He is past president of the National Association of Homebuilders (represents interest of for-profit developers of housing) and is a developer of multifamily housing -- primarily in Delaware -- including many projects that are backed by HUD project-based subsidies.

Sees HUD reinvention proposal as overreaction. W. said that he understands the Administration's goal of reducing the deficit and changing HUD programs so that they are more cost effective. However, both W. and C. said that HUD's MTM proposal was an overreaction to the Fall election; that the HUD "panic" to reinvent programs actually led Republicans to cut HUD more than they would have otherwise done; that the Republicans didn't have a plan before the HUD reinvention proposal and the proposal to provide tenant-based vouchers to residents of HUD-assisted multifamily properties (and public housing) was adopted as a starting place by the Republicans -- who then went a step further and began to cut budgetary resources. Evidence for this view was Joe Ventrone (House Banking Housing Subcommittee majority staff director) statement to W. to the effect that "we didn't have a plan before the HUD plan came along".

Concern about tenant-based voucher option. W. and C. both expressed concern abut the HUD proposal to eliminate the current system of project-based assistance and replace it with portable rental assistance certificates that could be used to meet rent payments in any building that tenants choose to live. Their concerns included the following:

(1) Scarcity of supply: W. stated that there is a limited amount of economically viable housing in many regions, so tenants won't be able to find housing with their vouchers. W. acknowledged that this argument does not apply to some areas where there is an excess of housing. (This argument is not supported by available HUD data on rental markets and experience with Section 8 assistance. Although HUD and Census data indicates that there is a growing number of people with "worst-case" housing need, most of this need is due to people not having sufficient income and thus paying in excess of 50% of their income to rent.)

(2) Moving would be difficult for seniors, families: Said that seniors/families would have trouble moving and that even the news about HUD's reinvention proposal is threatening to many seniors who think that they will be kicked out of their housing. (HUD's tenant-based proposal would allow tenants to stay rather than move if they choose.);

(3) Vouchers will be easy to cut: Said that Republicans would cut vouchers -- as they already have started doing in the FY 1996 appropriations -- and that project-based subsidies are more politically difficult to cut (Steve indicated that perhaps even easier for Congress to cut than vouchers are rules requiring subsidized projects to assist low-income persons -- which would result in poor people being replaced by middle income persons);

(4) Questions about budgetary savings. Michael McCullough questioned the HUD's estimated savings associated with MTM. Said that CBO had also questioned the savings (CBO and HUD/OMB are still discussing savings associated with MTM and CBO's original estimate was based on a lack of information as well as different scoring conventions.)

(5) Concern about bond market ratings. National Association of Home Builders staff expressed concern about the reaction of the bond rating agencies to the MTM proposal; Michael McCullough said that State and local bonds related to Section 8 project-based properties may be downgraded as a result of pending legislative proposals. Said bond downgrades would make it more difficult for State/local finance agencies to finance these and other projects. (Given the current fiscal environment and notwithstanding HUD's MTM proposal, it is unlikely that Congress would continue to provide excessive project-based subsidy payments to prevent mortgage defaults.)

Request for limited demo. W. said we need a few years of study on effectiveness of tenant-based approach; that we should have some pilot programs before doing national tenant-based voucher approach. Said Homebuilders would be willing to sit down with Administration to work out more limited proposal. (Steve indicated that HUD's voucher proposal would not be implemented immediately -- that the approach would be implemented over time as project-based rental assistance contracts expire and after a transition period -- generally two years. Note also that HUD negotiations with the Hill may lead to a more limited or incremental approach).

Request for meeting with President. W. reiterated his request for a meeting with the President to discuss his concerns.

JF

authority to require the conversion of public housing to vouchers in these limited cases as well as to recapture budget authority for those units and reuse it for replacement assistance.

The Committee mark includes a demonstration designed to test methods of limiting costs for FHA-insured and assisted multifamily properties. Unfortunately, and in contrast to the Administration's Mark-to-Market proposal, the demonstration as currently drafted would merely replace the current oversubsidization of many FHA-insured assisted projects with a more costly approach. The demonstration provides a new debt service subsidy to owners, ensuring them a profit regardless of market conditions. This is the opposite of the Administration's approach, which would expose properties to the market and give residents market power. A new subsidy program to preserve certain multifamily projects as low-income housing suffers is similarly flawed. The $550 million provided for this purpose could be better used to provide additional portable low-income housing subsidies. Neither provision would achieve the desired result and would, instead, perpetuate the current system of project-based, above-market subsidies. The newly authorized subsidies would be scored on a present-value basis as a substantial cost. Delaying the effect of these provisions until the following fiscal year avoids the immediate scoring problem but fails to correct the underlying problems of excessive cost and poor incentives.

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OMB Response

Matthew J. Domber
Domber and Ward
1700 McMullen-Booth Road
#C-3
Clearwater, FL 34619

Dear Mr. Domber:

Thank you for your letter on the Administration's Mark-to-Market (MTM) strategy. MTM was developed as a comprehensive approach to several longstanding problems in privately-owned and FHA-insured assisted housing. 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 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 followed, the cost of subsidies would continue to grow while physical stock problems would not be reversed. These are the structural problems of the current system that require comprehensive program re-design.

MTM addresses these problems by tying rental assistance to market rents and exposing insured properties to market forces, 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 shows 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. Long-standing problems of physical and financial viability will be addressed to the extent possible. Mortgages will be reduced to reflect the debt service that they could pay given other expenses and the amount of rental income the property will demand 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.

Many 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 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 granting low-income recipients some mobility.

Transitional assistance will soften the impact and 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.

Incremental strategies will not work given structural design flaws. Addressing your suggestion directly: reducing rental subsidies by paying partial FHA claims and thereby reducing a property's debt service would only take money out of one pocket of the Federal government and put it into another.

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. As in the savings and loan crisis, we have the choice of addressing the problems now and minimizing costs or delaying and ultimately facing much greater costs.

There has been a lively debate over MTM and we welcome all participants. Again, thank you for your thoughts.

Sincerely,

Alice M. Rivlin
Director