Honorable
President of the Senate
Washington, DC 20510

Dear Mr. President:

I am pleased to transmit proposed legislation to strengthen the Department's ability to sanction negligent owners of assisted housing. The legislation amends the Bankruptcy Code governing the powers of a bankruptcy court and the effect of the automatic stays as they relate to certain multifamily mortgages or other loans insured by the Departments of Housing and Urban Development and Agriculture.

This proposal would amend sections 105 and 362 of the Bankruptcy Code. The amendments to section 362 would exempt from the automatic stay provisions of the Bankruptcy Code actions taken by HUD and Agriculture toward foreclosure on multifamily housing projects with liens that are insured or held by either Department. The amendments to section 105 would make clear that the actions covered by the changes to section 362 are not subject to a bankruptcy court's discretion to issue stay orders.

These changes would allow HUD to proceed in a timely manner with foreclosure actions and to take all necessary and appropriate interim measures to protect the property, the FHA insurance fund, or the residents of HUD-insured or HUD-assisted multifamily housing projects from the potentially adverse impact of mortgagor bankruptcies.

As you know, one key priority of HUD over the last few years has been to improve the management of HUD's multifamily housing inventory. Significant administrative steps have been taken to increase the use of existing HUD enforcement tools and to develop new ones to ensure that the interests of the taxpayers, residents, and communities are served well. During 1995 and 1996, the Administration submitted legislation to strengthen enforcement powers, including extending equity skimming prohibitions, expanding the use of civil money penalties, and improving the operation of HUD's Mortgagee Review Board.

This initiative amending the Bankruptcy Code was among those proposals submitted in 1995 but was not acted upon. Legislative relief from the bankruptcy protections afforded to multifamily project owners can make HUD's enforcement efforts more effective because filing a petition in bankruptcy may well delay the imposition of sanctions.

An explanation and justification accompanies this letter and more fully sets out the contents of the bill. I request that the bill be referred to the appropriate committee and strongly urge its early enactment.

This draft bill could affect direct spending and receipts; therefore, it is subject to the pay-as-you-go requirements of the Omnibus Budget Reconciliation Act of 1990. The Office of Management and Budget estimates that the bill's pay-as-you-go impact will be zero.

The Office of Management and Budget advises that there is no objection to the enactment of this legislation from the standpoint of the Administration's program.

I am sending a similar letter to the Speaker of the House of Representatives, Newt Gingrich.

Sincerely Yours,

Henry G. Cisneros

Enclosure

A BILL

To amend provisions of the Bankruptcy Code governing the powers of a bankruptcy court and the effect of automatic stays as they relate to certain multifamily liens insured or held by the Secretary of Housing and Urban Development or the Secretary of Agriculture, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 105(b) of title 11 of the United States Code is amended to read as follows:

"(b) Notwithstanding subsection (a) of this section, a court may not:

"(1) appoint a receiver in a case under this title; or

"(2) issue any order, process, or judgment that operates as a stay of any of the acts excepted from automatic stay pursuant to section 362(b)(8).".

SEC. 2. Section 362(b)(8) of title 11 of the United States Code is amended to read as follows:

"(8)(A) under subsection (a) of this section, of any act by the Secretary of Housing and Urban Development or the Secretary of Agriculture included under subparagraph (B) relating to property that:

"(i) includes five or more living units and that is subject to a lien insured or held by the Secretary of Housing and Urban Development, including a lien held in the name of the United States of America acting by and through the Secretary of Housing and Urban Development;

"(ii) includes five or more living units and that is subject to a lien insured or held by the Secretary of Agriculture pursuant to title V of the Housing Act of 1949;

"(iii) is subject to a lien insured or held by the Secretary of Housing and Urban Development pursuant to title X of the National Housing Act, as it existed immediately before the effective date of the Department of Housing and Urban Development Reform Act of 1989;

"(iv) is a hospital or nursing home and that is subject to a lien insured or held by the Secretary of Housing and Urban Development;

"(v) is a project for the elderly or persons with disabilities subject to a lien held by the Secretary of Housing and Urban Development under section 202 of the Housing Act of 1959 or section 811 of the Cranston-Gonzalez National Affordable Housing Act; or

"(vi) is subject to a lien under section 312 of the Housing Act of 1964, as it existed immediately before October 1, 1991, except a lien on property or combinations of property with up to, and including, four living units, which property has no commercial space.

"(B) The acts of the Secretary of Housing and Urban Development or the Secretary of Agriculture referred to in subparagraph (A) include --

"(i) the commencement, continuation, or completion of any act or proceeding by either Secretary for obtaining and applying cash collateral; for obtaining possession pursuant to contract with the debtor or otherwise; for appointment of a receiver; for foreclosure of a mortgage or other lien; or for sale and conveyance of title to real or personal property; or

"(ii) any other act to protect the financial position or interest of either Secretary, which act is authorized under any applicable contract, regulatory agreement, regulation, or statute.".

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

EXPLANATION AND JUSTIFICATION

A BILL PROVIDING FOR THE EXEMPTION OF HUD AND AGRICULTURE MULTIFAMILY LOAN FORECLOSURES AND RELATED ACTIONS FROM THE BANKRUPTCY CODE

This bill would amend sections 105 and 362 of the Bankruptcy Code (Title 11 of the United States Code, as recodified by the Bankruptcy Reform Act of 1978 (Pub. L. 95-598; 92 Stat. 2549)). The changes to section 362 would exempt from the automatic stay provisions of the Bankruptcy Code those acts taken by the Secretary of HUD or Agriculture toward foreclosure (including acts to obtain possession or for the appointment of a receiver) on multifamily projects with liens that are insured or held by the Secretary of HUD, or by the Secretary of Agriculture pursuant to Title V of the Housing Act of 1949. Other acts to protect the financial position or interest of the Secretaries in bankruptcy situations relating to these projects would also be excluded from the automatic stay where a right (for example, to offset funding otherwise due to a debtor) is provided for under contract, regulatory agreement, regulation, or statute. The amendments to section 105 would make clear that the acts covered by these changes to section 362 are not subject to a bankruptcy court's discretion to issue stay orders.

This proposal requests restoration of the HUD position under sections 663 and 917 of the old Title 11 (repealed in 1978), which provided relief from the automatic stay for multifamily projects insured under the National Housing Act. A Court of Appeals decision extended those provisions to HUD-held mortgages. In addition to this restoration, the proposal would accord relief from the automatic stay for projects under the section 312 rehabilitation loan multifamily program under section 312 of the Housing Act of 1964, as it existed immediately before October 1, 1991 (since section 289 of the Cranston-Gonzalez National Affordable Housing Act repealed the Section 312 program as of such date); for land development projects under Title X of the National Housing Act, as it existed immediately before the effective date of the "Department of Housing and Urban Development Reform Act of 1989" (since section 133 of the Reform Act repealed Title X); for multifamily projects under section 202 of the Housing Act of 1959 or section 811 of the Cranston-Gonzalez National Affordable Housing Act; for hospitals and nursing homes under sections 242 and 232 of the National Housing Act; and for any other projects with mortgages held or insured by HUD under existing or now-dormant programs. It would also accord such relief for the Secretary of Agriculture under the multifamily program of the Rural Housing and Community Development Service (formerly, the Farmers Home Administration (FmHA)) in the Department of Agriculture.

Section 362(a) of the current Bankruptcy Code states the general rule that once a bankruptcy petition has been filed, there is an automatic stay imposed on the commencement or continuation of judicial, administrative, or other proceedings against a debtor. Section 362(b)(8) provides a narrow exception to the automatic stay rule, permitting the Secretary of HUD to commence foreclosure on a mortgage or deed of trust which is insured or was formerly insured under the National Housing Act, is held by the Secretary, and covers property or combinations of property consisting of five or more living units. This exception also leaves open the question of what constitutes "commencement" in a nonjudicial foreclosure since an "action" in the sense contemplated in section 362(b)(8) is not taken. The section 362(b)(8) exception, however, is considerably more restrictive than the analogous provision under the old Bankruptcy Act, and is too narrow to be fully effective in the protection of the FHA insurance fund and the tenants of HUD-insured or HUD-assisted multifamily housing projects from the potentially adverse impact of mortgagor bankruptcies. An expansion in the terms of the exception would be desirable for the following reasons.

The great majority of mortgagor-participants in HUD-insured or HUD-assisted multifamily housing projects are limited partnerships formed for the purpose of providing investor tax shelters. Defaults on mortgage obligations frequently reflect the financial incapacity of the mortgagor properly to manage and maintain the insured property. Defaults often lead to foreclosure. If the mortgagor declares bankruptcy, however, this will delay the foreclosure. Once in bankruptcy, the delinquent mortgagor has the positive tax advantage of continuing to take depreciation deductions, as well as other permissible deductions under the accrual method, sometimes without making mortgage payments. Under current law, HUD can commence foreclosure proceedings, but cannot prosecute them further. Moreover, in such situations, HUD may be stayed from protecting the Federal financial interests by taking such actions as off-setting with funds otherwise due a debtor. Prosecution of a foreclosure and other actions are thus delayed by the bankruptcy, to the detriment of the Federal government's financial interests and to the potential disadvantage of tenants -- many of them low- and moderate-income persons -- stemming from the physical deterioration of the affected projects.

To remedy this situation, the proposal would expand the existing exception to the automatic stay provisions in two respects. First, since the existing exception applies only to the <u>commencement</u> of a foreclosure action, the automatic stay still applies to any other step in the prosecution of a foreclosure, once commenced, and owners and their investors continue to enjoy the tax advantages until the automatic stay is lifted and the government's foreclosure action is completed.

Therefore, the proposal would permit prosecution of further steps, through the completion of foreclosure.

Second, because only the commencement of foreclosure actions is now exempt from the automatic stay provisions, actions to obtain possession as a mortgagee in possession or for the appointment of a receiver, or otherwise to protect the Federal financial interest, cannot usually be obtained on a timely basis. Pending a determination of whether foreclosure is necessary, it is highly desirable for the HUD Secretary to have these options, both for the protection of the FHA insurance funds and to protect tenants by assuring continued, satisfactory management and operation of multifamily housing projects in default. In this regard, the longer a property is tied up in bankruptcy, the more physical deterioration is likely and the greater is the need for intermediate remedies, such as receivership. Moreover, the longer the bankruptcy proceedings last, the more sharply reduced the proceeds of sale are likely to be, when finally permitted after foreclosure. (This problem is particularly serious for properties with section 312 rehabilitation loans, since these loans typically have a junior position among the liens on the property.)

In addition, the proposal would amend section 105 of the Bankruptcy Code, to prevent a bankruptcy court from invoking its other discretionary powers in a way that would frustrate the purposes of expanding the exemption from the automatic stay in section 362. The central concern is that unless section 105 is amended, section 362(b)(8) (even as amended under the proposal) would not necessarily protect the Secretaries of HUD and Agriculture, since a bankruptcy court could make injunctive or other equitable relief available to mortgagors in the exercise of its discretion under section 105. The benefits of the proposed exception to the automatic stay in section 362(b)(8) could thus be negated, if the bankruptcy court is free to exercise its power under section 105. Accordingly, the amendment to section 105 would prevent imposition of a discretionary stay on HUD and Agriculture in situations where, under the amendments proposed to section 362(b)(8), an automatic stay may not be imposed.

As noted above, this proposal would also expand the current exception in a further respect -- by extending the coverage that would be afforded to HUD's National Housing Act multifamily programs to hospital and nursing home programs under sections 242 and 232, respectively, of the National Housing Act; to Land Development programs under Title X of the National Housing Act (as it existed immediately before the effective date of the Department of Housing and Urban Development Reform Act of 1989); to the Section 312 Multifamily Rehabilitation Loan program under section 312 of the Housing Act of 1964 (as it existed immediately before October 1, 1991); to projects under section 202 of the Housing Act of 1959 or section 811 of the Cranston-Gonzalez

National Affordable Housing Act; and to any other projects with mortgages held or insured by HUD under existing or now-dormant programs; and to the Department of Agriculture's Multifamily Rural Housing program. Thus, for these additional programs as well, the proposed amendments would ensure that the Secretaries of HUD and Agriculture have adequate and timely recourse against defaulting mortgagors, and would permit acts short of foreclosure (such as the Secretary of HUD or the Secretary of Agriculture taking possession or seeking appointment of a receiver). There seems to be no relevant basis upon which these additional programs should be distinguished from the National Housing Act multifamily programs for Bankruptcy Code purposes.

One technical item deserves mention. Under existing section 105, a bankruptcy court may not appoint a receiver, and that prohibition is carried into the proposed revision. Nonetheless, the proposal would permit the Secretary of HUD or Agriculture to appoint a receiver for the specific property involved. These provisions are not contradictory because of differences in who may appoint the receiver and the jurisdiction that the receiver may have, such as supervision of an affected property versus the estate of a bankrupt.

E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

26-Jun-1996 12:39pm

TO: Molly Brostrom

FROM: Francis S. Redburn
Office of Mgmt and Budget, HTF

SUBJECT: RE: House approps

The two sections you cite were dropped last night through passage of a floor amendment offered by Lazio. He objected because this was authorizing language.

They are (or were) actually a fairly complete version of portfolio reengineering, which FHA provided technical drafting assistance to the appropriations committee. However, the language would have affected only high-cost projects with Section 8 assistance contracts expiring in 1997.

They did not apply to seniors in particular. As you know, in both last year's proposal and this year's -- and in the language that was stripped last night -- seniors (and other sitting tenants) would not have been required to move or pay higher rents.

Call me if you want more explanation.

Has Bruce talked to Jeremy yet?

PREVIOUSLY CLEARED (4/96)

HUD POSITION PAPER: PORTFOLIO REENGINEERING

EXECUTIVE SUMMARY

Over the next seven years, subsidies will expire on nearly 800,000 units in apartment buildings that receive Section 8 rental assistance and have mortgages insured by the Federal Housing Administration. Budget resources do not exist to renew these contracts at their current subsidy level. If contracts are not renewed, hundreds of thousands of low-income families will be adversely affected in many communities, and the federal government will be forced to pay insurance claims on up to $18 billion of privately-held mortgages.

Even if sufficient resources were available, structural problems in the Section 8 program have reached critical proportions. Based on a statistically valid sample of the portfolio reengineering universe, 64.5 percent of these units -- approximately 510,000 units -- have HUD-paid rents higher than market-rate rents for comparable units -- in some cases substantially higher. At the same time, many assisted properties -- particularly those financed under older programs -- are in poor physical condition. Eighty-six percent of these "Older Assisted" properties have deferred maintenance and capital needs greater than $5,000 per unit.

In 1995 and early 1996, the Administration, in many cases working with Congress, took important interim actions to begin addressing this crisis. In May 1995, HUD put forward an historic initiative to reform Section 8 project-based assistance. Since then, the Department has conducted a broad outreach effort involving all of the constituencies that would be affected by changes in the program. These discussions, which are continuing, have led HUD to modify the initiative -- now known as "portfolio reengineering." As an interim measure, Congress agreed to extend Section 8 contracts that were expiring in 1996 for one additional year. While this action provides affected stakeholders more time to resolve the problem, Congress has made it clear that the status quo cannot continue.

HUD's approach to portfolio reengineering includes the following guidelines:

- Focus on higher-risk properties
- Act proactively and efficiently
- Protect residents and communities
- Recognize the diversity of the portfolio and owners

For 1996-1997, the portfolio reengineering initiative will focus on properties with rents over market. For properties with Section 8-subsidized rents below market, the Department is continuing to review with the various stakeholders approaches to solving the capital needs of these properties and expiring contracts.

April 9, 1996

Under HUD's proposal, local and state governments would be involved in deciding whether future assistance on these properties comes in the form of tenant-based assistance or continues to be linked to the property -- depending on what is in the best interest of their communities. If continued, project-based subsidies would be at market rental rates. Residents in properties which do not continue as project-based would receive housing certificates, which they could use to remain in their current units or to rent housing of their choice elsewhere. For properties that would not be financially viable without federal subsidies at current levels, HUD would assist in writing down the property's debt to a level that can be supported by market rents.

HUD's preferred approach is to restructure the financing on properties and provide for rehabilitation *before* Section 8 contracts expire. This would make it easier for responsible owners to remain in place and would protect against property disinvestment. HUD would undertake this proactive reengineering by entering into partnerships with third-party entities that are experienced in restructuring real estate and sensitive to public policy goals. The third-party entities would operate under carefully established HUD guidelines and would help properties make the transition to market on a property-by-property basis. HUD lacks the capacity to respond to the needs of each property individually.

BACKGROUND

Over the next seven years, subsidies will expire on nearly 800,000 units in apartment buildings that receive Section 8 rental assistance and have their mortgages insured by the Federal Housing Administration. (More than 500,000 units expire in the next four years alone.) The cost of renewing these Section 8 contracts at their current levels is far greater than can be supported within current fiscal constraints. If the contracts are not renewed, however, hundreds of thousands of low-income families will be adversely affected, and the federal government will pay insurance claims on upwards of $18 billion of privately-held mortgages.

Even if sufficient budgetary resources were available to maintain the current system, structural flaws in the program that created the problem would remain. HUD is both the mortgage insurer and the subsidy provider for these apartment buildings. This overlap has resulted in the federal government averting claims against the FHA insurance fund only by supporting a subsidy and regulatory structure that has masked the true market value of the properties.

This system has also created many circumstances in which owners view HUD--and not residents--as the true "customer." As a result, many federally assisted properties do not provide the kinds of services or amenities that non-federally assisted buildings--charging the same or higher rents--provide to their residents. Historically, Congress and previous administrations have treated the symptoms but not addressed the underlying flaws in this program.

The Section 8 program was enacted during the Nixon Administration to stimulate production of affordable rental housing. In exchange for housing lower-income residents, the program provided federal assistance to properties for a designated number of years, set forth in contracts between HUD and the apartment owner. The contracts typically ran for 20 years. Today -- 20 years later -- a large wave of Section 8 contracts has begun to expire. In recent years, Congress has tended to renew most expiring contracts for shorter and shorter terms. The expiration wave is building -- including contracts on more than 200,000 units in FY 1997.

Section 8 properties divide generally into two categories: "Older Assisted" and "Newer Assisted."

The Older Assisted properties were mainly constructed beginning in the late 1960s under a variety of mortgage subsidy programs, including Section 236 and Section 221(d)(3). These programs enabled owners to finance their properties at below-market interest rates (BMIR). Section 8 assistance -- in the form of Loan Management Set Aside (LMSA) contracts -- was added later to these units, beginning in the mid-1970s, to help defray operating costs which had begun to rise sharply in response to inflation and soaring energy prices.

A second group of Section 8 properties -- Newer Assisted -- was built after 1974. These properties received federal subsidies based on set formulas with automatic annual adjustments. The formulas tended to be relatively generous to encourage production.

Unfortunately, the Section 8 support system today is breaking down. Almost two-thirds of the FHA-insured Section 8 properties now receive federal subsidies above market levels. In many cases, the subsidies are well above the rents charged for comparable non-subsidized units in the same neighborhood. This not only drains scarce federal housing resources; it also weakens public support for assisted housing programs across the board. About 90 percent of the Newer Assisted properties are subsidized at rents above the market rate.

Over-subsidization is not the only problem. Another large group of Section 8 properties -- mainly in the Older Assisted group -- is under-subsidized and consequently has limited ability to make necessary physical repairs and to deal with deferred maintenance needs. A substantial portion of these properties is in distressed condition. No matter how badly these buildings deteriorate, however, most tenants cannot move because they would lose their rental assistance since the rental assistance provided is tied to the building, not to the tenant.

THE ADMINISTRATION'S APPROACH

To grapple with this problem, HUD started planning in late 1994 to re-engineer this portion of its multifamily portfolio. Among its guiding principles, HUD seeks to insure to the maximum extent possible (a) protection of residents from displacement or rent increase, (b) stability in the neighborhoods in which these apartment buildings are located, and (c) protection for the legal rights of apartment owners. All of these objectives must be balanced within the serious budget constraints and reduced personnel capacity of HUD.

Portfolio Reengineering: Properties Included

To be included in the portfolio reengineering initiative, a project must receive Section 8 project-based assistance <u>and</u> have an FHA-insured mortgage. Such properties are included because:

1) If Section 8 project-based subsidies on these properties are cut back, many owners will not have sufficient revenues to pay their operating costs and mortgage payments. They will default on their FHA-insured mortgages, and the federal government will be forced to pay billions of dollars in mortgage claims.

2) The presence of FHA mortgage insurance on these properties provides HUD a vehicle to help restructure the project's debt to a level that can be supported by market-rate subsidies.

Properties included beginning in 1996-1997	Properties under review for inclusion after 1996-1997	Properties not included in Portfolio Reengineering
Properties with Rents Above Market	Properties with Rents Below Market	Section 236 w/o LMSA Section 221(d)(3) BMIR w/o LMSA Section 8 Mod Rehab Section 202/811 Any Section 8 property <u>not</u> FHA insured

While properties that receive project-based assistance but are not FHA-insured are excluded from the portfolio reengineering initiative, they will be affected if their Section 8 assistance contracts are not renewed at current levels.

Operational constraints on properties not administered by HUD's Office of Housing have led to the exclusion of the Section 8 Moderate Rehabilitation properties -- even though they are both FHA-insured and receive project-based assistance. These properties may be handled in later phases of reengineering.

No Section 202 properties are included in the portfolio reengineering proposal. This uninsured portfolio is unique, with budgetary ramifications outside of the Department. These properties will continue to be assisted under the current system.

For 1996-1997, the portfolio reengineering initiative will prioritize properties with rents over market. For properties with Section 8-subsidized rents below market, the Department is continuing to review with the various stakeholders approaches to solving the capital needs of these properties and expiring contracts.

Portfolio Reengineering: How It Works

When they expire, Section 8 assistance contracts between HUD and project owners will not, as in the past, be automatically renewed at their current levels or in their current form. Local and state governments will be involved in deciding whether future assistance on these properties comes in the form of tenant-based assistance or continues to be linked to the property -- depending on what is in the best interest of their communities. For properties that would not be financially viable without rent subsidies at current levels, FHA would facilitate the replacement of the existing FHA-insured mortgage with a smaller mortgage that can be supported by the project at market-rate rent levels. Upon restructuring, the FHA mortgage would be extinguished. Property owners could apply for FHA insurance on the new loan, which could then be properly underwritten given current conditions, and scored for credit subsidy purposes.

Key Components

After extensive discussions with affected constituencies--residents, property owners, lenders, community groups, local and state governments--HUD is proposing to re-engineer the way it supports this part of its multifamily portfolio by changing the relationship between HUD-provided subsidies and FHA-insured debt. HUD's approach to portfolio reengineering includes the following components:

Focus on Higher-Risk Properties:

- For 1996-1997, HUD will prioritize properties with rents over market.

- For properties with Section 8-subsidized rents below market, HUD will continue to discuss in 1996 with various stakeholders approaches to solving the severe capital needs of these properties and expiring Section 8 contracts. However, HUD notes that the bulk of the properties with rents below market have Section 8 contracts that are among the first wave of expirations in 1996-1999. Many of these buildings are in poor condition or have significant amounts of deferred maintenance, leaving their residents to live in inadequate conditions and creating problems for surrounding neighborhoods. The needs of these apartment buildings and the families who live in them cannot be forgotten, but must also be addressed by future legislative action.

Act Proactively and Efficiently:

- Section 8 contracts on over-subsidized properties would not be renewed at current rents but would be reduced to market levels. To convert to market-based rents, however, FHA must also simultaneously reduce the underlying mortgages to levels sustainable at the new rent levels. Mortgages can be refinanced at lower levels because FHA insures the mortgages and can pay claims to existing lenders for the required reduction in mortgages.

- HUD does not have the current staff to devote to handling thousands of individual transactions; any approach to portfolio reengineering must use third parties. HUD proposes to use third parties to workout, restructure, and resolve mortgages subsidized by Section 8 contracts before the Section 8 contracts expire. HUD would strongly prefer--as would owners, residents, lenders, and communities--that mortgages be resolved in advance of contract expirations, thus preventing defaults. These third parties would receive strict guidance and oversight from HUD about the public purposes that must be achieved in the process of restructuring, including protecting residents and communities, and ensuring that properties will be financially viable post-restructuring. More detail about this approach follows.

Protect Residents and Communities:

- Local and state governments should be involved in deciding the form of rental assistance provided to a property post-restructuring--whether the assistance is project-based or tenant based--depending upon what is in the best interests of their communities. If continued, however, project-based assistance would have to be at market rental rates, and the deliberate over-subsidization would stop.

- Residents of these buildings must be protected from displacement to the greatest extent possible. HUD is proposing that existing residents, if they receive tenant-based assistance, would receive "enhanced vouchers" that would pay the difference between 30 percent of their income and the market rent established for the buildings in which they live--even if it exceeds fair market rent, so long as it meets the rent reasonableness requirements of the local PHA.

- In addition, many unassisted, low-income households living in projects that would be included in portfolio reengineering currently receive an indirect subsidy through low project-based rents. Income-eligible residents who are currently living in a unit without Section 8 assistance also would be entitled to rent subsidies if their rents increased above 30 percent of income as a result of restructuring and the local government chose not to continue project-based subsidies.

Recognize the Diversity of the Portfolio and Owners:

- Any solution designed to address the expiration of Section 8 contracts and reduced budgetary resources for housing must recognize that a single solution will not work for the different types of properties and communities affected by portfolio reengineering.

- The properties affected by portfolio reengineering divide generally into three basic groups: 1) properties that could operate on a solid financial basis at market-rate rents; 2) properties that could not operate on market-rate rents and would require mortgage restructuring; and 3) properties that at market rents could not pay operating expenses, even if FHA completely wrote off all mortgage debt. The small segment of the portfolio in category 3 will require special handling, including a change in unit mix or ownership, additional financial assistance provided by local governments, or even partial or complete demolition.

- The tax consequences of portfolio reengineering on owners could be a barrier to proactive resolution. The Administration is willing to discuss with Congress mechanisms to take account of tax consequences related to debt forgiveness for property owners who enter into restructuring agreements with HUD.

- Forceful action should be taken against bad owners and managers; they should not benefit in any way from portfolio reengineering.

PROACTIVE RESOLUTION OF THE SECTION 8 PORTFOLIO USING THIRD PARTY PARTNERS

Initially, HUD envisioned that it would restructure each of the mortgages on FHA-insured and Section-8-subsidized properties individually, but operational constraints at the Department made such an approach unworkable. HUD then considered relying on mortgage sales to resolve the Section 8 portfolio. But it soon became clear that mortgage sales also would not be appropriate because owners would have to default before restructuring could occur -- something the Department does not want to occur.

After much input, HUD decided that the optimal approach for tenants, communities, Section 8 owners and taxpayers would be to use third-party entities to resolve Section 8 mortgages — and to have them do so <u>before</u> contracts expire. Such an approach is preferable because:

- The capacity to act before mortgage defaults will speed property transitions to market and greatly reduce the likelihood of property disinvestment and physical decline.

- The third-party entities will have the specific capacities required to devote individual attention to each mortgage and underlying property, engaging the expertise needed to foster financial integrity, strong management and solutions tailored to community needs.

- Responsible owners will be able to retain ownership interests in their properties — rather than be forced to default when their Section 8 contracts expire and cannot be renewed at current levels.

- From a financial standpoint, the ability to act before contracts expire will maximize the value of the Section 8 portfolio, ensure the widest possible opportunities and options are available for restructuring the mortgages, and minimize the potential for foreclosures and FHA insurance claims.

- Through a trust structure with the third-party entities, the Department will be able to take the proceeds resulting from mortgage restructurings and dispositions and apply them to fund rehabilitation of dilapidated properties.

- A trust structure permits long-term tenant and community protections to be imbedded in any resolution through instructions to third-party entities.

Proactive Resolution by Third Parties: How It Works

HUD would transfer the economic liability for a designated portion of the FHA-insured mortgages in its Section 8 portfolio to competitively selected third-party entities. The entities could be teams composed of local and state government entities (including HFAs), nonprofits, asset managers, and capital partners. They could be pre-qualified to ensure they had sufficient expertise in the management and disposition of HUD mortgages and properties.

After completing due diligence on the underlying properties, the third-party entities would negotiate with lenders and owners and conduct workouts, debt restructuring, mortgage sales or other resolution alternatives. All Section 8 contract obligations and rights would be honored, and the third-party entities would also be required to satisfy specific public-policy objectives — such as the protection of tenants and communities and the rehabilitation of distressed properties to the extent feasible.

HUD and the third-party entities would share in proceeds generated by such mortgage resolutions through the establishment of a trust structure. The use of a trust structure, under which HUD retains an ongoing passive interest, would also ensure that HUD's private partners are not given a "windfall" in restructuring the Section 8 portfolio. The third-party entities would be required to pledge significant capital to participate in this program. This will ensure they have sufficient incentives to maximize profits and minimize costs.

HUD anticipates using multiple third party entities, depending on the characteristics of the Section 8 mortgages and properties involved. The entities would generally include:

- State housing finance agencies – to provide a source of financing for restructured mortgages, to help monitor implementation of the public purpose objectives, to service and own mortgages and to help value properties.
- Local government entities – to accept donated mortgages and properties, to help monitor implementation of the public purpose objectives, to purchase certain types of mortgages and properties, and to help value properties.
- Traditional asset management firms – to workout, restructure and dispose of mortgages.
- Capital partners – to provide equity funds.
- Asset servicers – to service the performing mortgages.
- Primary and secondary market lenders – to provide underwriting services for restructured mortgages and a facility for rehabilitation loans.
- Nonprofit organizations and intermediaries – to accept donated mortgages and properties, to help monitor implementation of the public purpose objectives, to purchase certain properties, and to provide technical expertise.

Why Independent Third-Party Entities Are Preferable

In proposing this structure, HUD has also considered other approaches involving third parties to resolve Section 8 mortgages. These have included suggestions to use contractors or a Resolution Trust Corporation–type entity. HUD believes the third-party entities described above, particularly in certain markets, are better than other alternatives.

HUD Contractors. While contractors could be engaged directly by HUD to perform many of the functions required, it will be difficult, if not impossible, to structure sufficiently strong and clear incentives to achieve maximum results using this approach. In its experience, the RTC found it difficult to delegate asset management and disposition decisions to contractors.

State Housing Finance Agencies. HUD wants HFAs to participate as a member of the third party entity teams, but, in most markets, HFAs alone could not handle the thousands of properties that will be affected by portfolio reengineering. The state HFAs, given their other considerable responsibilities, do not have the ability to undertake thousands of complex mortgage resolutions with multiple property owners and lenders. In addition, HFAs would in many cases be unwilling to take on the kinds of financial risks associated with these transactions by themselves, because HFAs serve a variety of public purposes, including protecting the fiduciary interests of their state governments and taxpayers.

An RTC–type entity. It would be a mistake to delegate responsibility for restructuring this portfolio to a "resolution" agency, even one with substantial experience at asset management and disposition. The regulations and laws governing Section 8 programs are complex and intricate, and require a level of expertise far beyond standard asset management. This resolution must occur consistent with HUD's underlying programmatic goals, including the protection of tenants and communities. "Resolution" agencies are not charged with or experienced with these important responsibilities. In addition, in this era of government downsizing, the creation of a new resolution entity that requires its own staff, budgets, and resources would not be a prudent use of scarce budgetary resources.

CONSEQUENCES OF NOT ACTING

The consequences of not acting are severe. As Section 8 contracts expire, Congress could choose to renew them for one-year terms, but would be unlikely, given the budget constraints, to renew them for multiple one-year terms at above-market rents. As a result, owners could be expected to default in large numbers on their FHA-insured mortgages, producing massive losses for the FHA Fund and hurting communities and residents that rely on these affordable housing resources. Or, if Congress continued to renew expiring Section 8 contracts at current, over-subsidized rents, these renewals would consume the vast majority of HUD funding in a few years. Only a small portion of the HUD budget would remain for all of the other housing and community development needs addressed by HUD.

BUDGET AND SCORING IMPLICATIONS OF PORTFOLIO REENGINEERING

Portfolio reengineering affects spending in both discretionary (Section 8 rent subsidies) and mandatory (FHA claims and related expenses) categories of the Federal Budget. The total financial impact of the proposal can be examined from either a programmatic perspective (total cost to government), or from a Budget Enforcement Act (BEA) scoring perspective (scoreable impact of legislation).

From the programmatic perspective, portfolio reengineering is cheaper than maintaining the status quo. Compared to current law, which limits renewal of rent subsidies to no greater than 120 percent of fair market rents, the proposal saves $4.4 billion on a present value basis over 25 years. These savings are a result of both lower rent subsidies and lower claims payments.

From the BEA perspective, the effect of portfolio reengineering legislation would be scored under "pay-as-you-go" (PAYGO) procedures for only its effects on mandatory spending. The baseline (spending under current law) must be used for comparison. The current FHA baseline assumes a higher level of claims than in the past, reflecting recent Congressional action limiting or capping rent subsidies. Portfolio reengineering produces savings compared to this baseline by giving HUD new authority to proactively restructure projects, using private third-party partners with incentives parallel to those of the Government. Although these proactive efforts produce larger claims in the near term, the resulting savings over the long-term exceed the short-term costs.

Under the Federal Credit Reform Act, the savings from this legislation are scored as the net present value of the change in cost (measured against the baseline) resulting from the combination of increased spending and reduced costs. The net savings from the Administration's proposal are $1.4 billion, which would be scored as PAYGO savings in the year of enactment. An important assumption in these estimates is that use of third parties results in increased efficiency--and therefore more savings to the Government--than merely granting HUD more authority to perform the restructuring itself.

A related scoring issue is how to treat proposals that would allow for the bifurcation of the FHA-insured debt by creating a "soft second mortgage" in lieu of a direct claim payment. These proposals are designed to address the problem of tax liability created for many owners if project debt is cancelled. Bifurcation could be used to write down the mortgages by assigning a portion of outstanding debt to a note for which collection is, at best, unlikely. There are budget scoring difficulties with this approach. In nearly all cases, creation of a second mortgage constitute a loan modification under the Federal Credit Reform Act, and would require the use of budget authority to reflect the cost of changing the terms of the loan. In addition, if the probability of collecting the second note is low, the IRS will consider it debt forgiveness and it will become taxable income for the owner. If the tax problem is avoided by increasing the likelihood of collection (making the second "less soft"), it could be seen as a new loan and would thus require additional appropriations under Credit Reform.

April 9, 1996

FURTHER BACKGROUND ON ADMINISTRATION HOUSING INITIATIVES:

One Strike policy: On March 28, the President directed HUD Secretary Cisneros to distribute to all public housing authorities new national guidelines that set forth the framework for implementation of effective "One Strike and You're Out" programs. The "One Strike" policy uses statutorily authorized applicant screening and tenant eviction procedures to keep out drug dealers and other criminals who threaten the safety and well-being of residents.

Operation Safe Home: A collaborative initiative between federal, state, and local law enforcement, public housing staff and residents to get rid of the worst infestations of gangs, drugs and violent crime in public housing developments. Thousands of criminals have been arrested and hundreds of assault weapons and $3 million worth of drugs have been confiscated as a result of this initiative.

HOME: The HOME program provides grants to states, local government, and Indian tribes to implement local housing strategies that are designed to increase homeownership and affordable housing among low- and very low-income Americans. Funds can be used for a variety of housing activities, according to local needs (tenant-based assistance; housing rehabilitation; new construction; assistance to first-time homebuyers).

Through increased funding and a streamlined and more effective HOME program, the Administration, working with state and local governments, has significantly increased housing and rental assistance to families. To date, the Administration has provided almost 200,000 families with housing assistance through the HOME program and over 26,000 families with HOME tenant-based rental assistance. Since 1993, the Administration has increased funding for the HOME program by 40% to $1.4 billion.

LIHTC: Created by the Tax Reform Act of 1986, the Low-Income Housing Tax Credit (LIHTC) program authorizes states to issue federal tax credits for the acquisition, rehabilitation, or new construction of affordable rental housing. As he promised during the 1992 campaign, President Clinton permanently extended the LIHTC; he has successfully fought off Republican proposals to sunset the credit. The LIHTC helps to produce almost 60,000 homes each year.

FHA Multifamily Portfolio Reengineering: Over the next seven years, subsidies will expire on nearly 800,000 units in apartment buildings that receive Section 8 rental assistance and have mortgages insured by the Federal Housing Administration. Budget resources do not exist to renew these contracts at their current subsidy level. If contracts are not renewed, hundreds of thousands of low-income families will be adversely affected, and the federal government will be forced to pay insurance claims on up to $18 billion of privately-held mortgages.

In addition, structural problems in the Section 8 program have reached critical proportions. It is estimated that 63% of these units -- approximately 500,000 units -- have HUD-paid rents higher (sometimes substantially higher) than market-rate rents for comparable units. At the same time, 86% of the older assisted properties (financed under older programs) are in poor physical condition (have deferred maintenance and capital needs greater than $5,000 per unit).

In 1995 and 1996, the Administration proposed reforms (the first broad reforms called "Mark-to-Market", the current modified ones are referred to as "Portfolio Reengineering" to begin addressing these problems. In working toward reform, HUD has reached out to Congress as well as all of the constituencies that would be affected by changes. HUD's reforms focus on the high-risk properties with rents above market. HUD continues to work with Congress to incorporate elements of portfolio reengineering in the appropriations process -- the House stripped these provisions from their bill; the Senate is expected to include very moderate, if any, proposals.

LEVEL 1 - 3 OF 6 STORIES

The New York Times

July 18, 1996, Thursday, Late Edition - Final

SECTION: Section D; Page 2; Column 1; Business/Financial Desk

LENGTH: 812 words

HEADLINE: Economic Scene;
Another Government bailout, a mere $18 billion at risk.

BYLINE: By Peter Passell

BODY:

READY to ante up for another financial fiasco generated by regulatory myopia? Just when you thought the cost of the savings and loan debacle was pretty much past, the next Government bailout is about to hit, revolving around federally insured mortgages on subsidized housing for the poor.

This time, the cost will be much smaller: A mere $18 billion is at risk compared with more than $130 billion that taxpayers shelled out to pay off depositors at failed savings institutions. But the real question, argues Robert Litan, director of economic studies at the Brookings Institution, is whether Washington will end up paying a little now or a lot more later to clean up the mess.

While 1.4 million poor families live in Government-owned housing, 700,000 more rent private apartments that would not have been built -- and could not be maintained -- without Federal subsidies. Owners of this Section 8 housing, named for a part of the law administered by the Department of Housing and Urban Development, negotiated "fair market rents" with the Government when the units were built in the 1970's and early 80's. Tenants pay 30 percent of their incomes to the landlords, with the difference paid by Washington.

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Economists do not like this "Soviet style" system, as Mr. Litan, who was a top budget official in the Clinton Administration for a while, terms it, because the negotiated rents are no more determined by competitive market forces than the price the Pentagon pays for B-1 bombers. Mr. Litan and James Barth of Auburn University, estimate that two-thirds of the apartments rent for premiums over the local competition.

Tenants are not wild about the system, either. Since their subsidies are tied to the building, they are effectively prisoners of their landlords.

The real estate industry loved the system, but politicians are finally tiring of playing Uncle Sucker. "In an era of budget scarcity how can you defend a system in which the Government pays more than everybody else?" asks Nicolas P. Retsinas, Assistant Secretary of H.U.D.

But, in this highly partisan era where the Republicans rule in Congress and President Clinton runs the White House, reaching a consensus is never easy. And

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this problem is tough, because the renegotiation of overpriced subsidy contracts and the conversion of building-specific subsidies to housing vouchers useful anywhere won't get the Government off the financial hook. Mortgages on the subsidized buildings are all federally insured. And while no one knows the exact numbers, it is widely agreed that landlords would default on the great majority if H.U.D. allowed their rental income to fall to competitive levels. Hence from Washington's perspective, Mr. Litan notes, "it's pay now or pay later."

Make that "pay more later," much more. Unless Congress extends building-specific subsidies indefinitely -- an implausible outcome in light of the Federal budget crunch -- the Government will have to foreclose on hundreds of thousands of occupied units. H.U.D. estimates the foreclosure route would add $5 billion to the cleanup cost.

A tidier, cheaper fix, proposed by the Clinton Administration in 1995, would eliminate building-linked subsidies as the current contracts expire. The Government would voluntarily take a one-time hit by relieving building owners of a portion of their mortgage liability. Meanwhile, tenants in previously subsidized units would get housing vouchers that would give them the option of staying put or shopping for something better.

The Republican Congress took a rain check on serious consideration of the proposal. Instead, it extended expiring subsidy contracts for one year -- no big deal since fewer than 1 percent expired in 1996. And it gave H.U.D. authority to restructure the mortgages on a token 15,000 units. But subsidy contracts for 236,000 units expire next year.

Now the Clinton Administration is back with a revised proposal. The plan would pay third parties -- including state and local housing agencies -- to take over the Federal mortgage liabilities and make the best deals they could with landlords losing their above-market subsidized rents. Uncle Sam would share in any profits associated with hard bargaining. To win over the real estate lobby, the Administration has also signaled that it would not oppose tax breaks for landlords who would otherwise be forced to pay capital gains levies on any savings on their mortgage.

A bipartisan settlement of so complex and potentially embarrassing a problem along these lines may seem out of reach in a Presidential campaign. But Mr. Retsinas is cautiously optimistic. There is quiet agreement in Congress that future subsidies for affordable housing must be untangled from past errors in housing finance -- and at minimal taxpayer cost. "This," Mr. Retsinas says hopefully, "is no longer about ideology."

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LANGUAGE: ENGLISH

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STATEMENT BEFORE THE

HOUSE GOVERNMENT REFORM AND OVERSIGHT COMMITTEE

SUBCOMMITTEE ON
HUMAN RESOURCES AND INTERGOVERNMENTAL RELATIONS

BY
NICOLAS RETSINAS
ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISSIONER

WASHINGTON, DC
July 30, 1996

INTRODUCTION

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

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

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

Improved Portfolio Management

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

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

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

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

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

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

Asset Sales

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

-- Multifamily notes have been sold through a program of mortgage sales. From 1994 to 1996, HUD sold 927 loans with an unpaid principal balance of $2.9 billion, thus reducing asset managers' dangerously high workloads. Further, the loan sales generated over $2.1 billion in proceeds to the taxpayers.

-- Included in the mortgage sales program was a June 1996 structured finance transaction involving 158 loans with an unpaid principal balance of $885 million. The projects represented by these loans included approximately 6,400 units of subsidized housing. This sale resulted in $585 million in proceeds to the taxpayer.

- what happens to tenants

Improved Tenant Involvement

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

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

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

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

Improved Enforcement Activities

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

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

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

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

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

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

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

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

THE NEED FOR PORTFOLIO REENGINEERING

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

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

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

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

Some Progress but Fundamental Problems Remain

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

-- We acknowledged that the status quo and paying above market rents for assisted housing is no longer sustainable in today's budgetary climate.

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

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

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

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

History of Over-Subsidization

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

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

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

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

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

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

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

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

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

Budgetary Issues

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

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

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

Operational and Policy Issues

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

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

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

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

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

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

ADMINISTRATION'S PROPOSAL

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

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

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

3. Provide appropriate solutions for the tax issues confronting the owners of the property as a result of restructuring -- that is, cancellation of debt recognized as income.

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

Analysis of the Portfolio

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

Size of Portfolio

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

Problem is serious

-- 63 percent have rents greater than market rents

-- 37 percent have rents less than market rents

Physical condition of properties

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

Portfolio reengineering can solve the problem

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

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

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

One size does not fit all

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

Overarching Principles

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

* Residents and neighborhoods must be protected.

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

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

* There will be no abrogation of contracts.

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

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

Costs Savings

In preparing the Administration's FY 1997 budget, $1.4 billion in mandatory savings and $1.8 billion in discretionary Section 8 savings were estimated for the period 1997-2002 under the Administration's portfolio reengineering proposal. In discussions with Congressional Budget Office staff, we understand that CBO may have reached a different conclusion about the mandatory savings from portfolio reengineering as presented in the President's budget. These differences appear to be based upon different assumptions about recovery rates or, in other words, levels of payments to reduce mortgages and the benefits of providing owners with an option to restructure before contract expiration (known as proactivity).

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

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

HUD's Capacity

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

-- historical knowledge and program expertise;

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

-- capital to pay claims and refinance debt;

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

-- extensive troubled workout experience;

-- community linkage; and

-- capacity to work with residents and define services.

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

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

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

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

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

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

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

ALTERNATIVE OPTIONS AND CHOICES

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

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

How Rents Are Set

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

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

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

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

Third Parties

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

-- No use of third parties and simply allow the mortgages to be managed by HUD staff;

-- Public or private contractors who would administer the restructuring process for a fee;

-- Entities who would put up capital and take risks in return for monetary rewards when the restructuring process succeeds beyond some predetermined benchmark; and

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

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

FHA Insurance

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

-- No FHA insurance

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

-- Full FHA Insurance

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

Tax Solutions

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

A bifurcation of the project debt would also add to the cost of any portfolio reengineering proposal because the second mortgage would be scored as a loan modification that would use appropriated credit subsidy.

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

Responses to Administration's Proposal

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

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

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

CONCLUSION

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

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

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

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

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

Economic Scene | Peter Passell

Another Government bailout, a mere $18 billion at risk.

READY to ante up for another financial fiasco generated by regulatory myopia? Just when you thought the cost of the savings and loan debacle was pretty much past, the next Government bailout is about to hit, revolving around federally insured mortgages on subsidized housing for the poor.

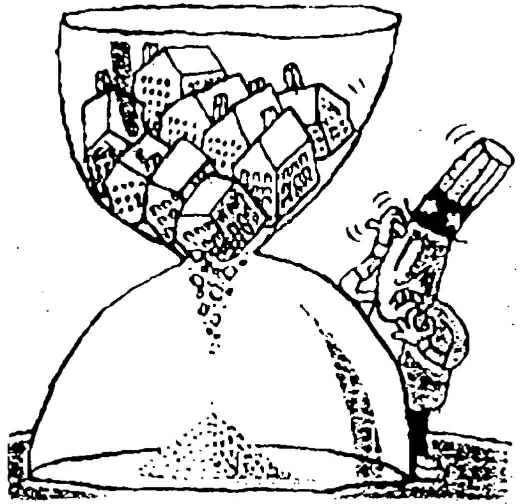
This time, the cost will be much smaller: A mere $18 billion is at risk compared with more than $150 billion that taxpayers shelled out to pay off depositors at failed savings institutions. But the real question, argues Robert Litan, director of economic studies at the Brookings Institution, is whether Washington will end up paying a little now or a lot more later to clean up the mess.

• • •

While 1.4 million poor families live in Government-owned housing, 700,000 more rent private apartments that would not have been built — and could not be maintained — without Federal subsidies. Owners of this Section 8 housing, named for a part of the law administered by the Department of Housing and Urban Development, negotiated "fair market rents" with the Government when the units were built in the 1970's and early 80's. Tenants pay 30 percent of their incomes to the landlords, with the difference paid by Washington.

Economists do not like this "Soviet style" system, as Mr. Litan, who was a top budget official in the Clinton Administration for a while, terms it, because the negotiated rents are no more determined by competitive market forces than the price the Pentagon pays for B-1 bombers. Mr. Litan and James Barth of Auburn University estimate that two-thirds of the apartments rent for premiums over the local competition.

Tenants are not wild about the system, either. Since their subsidies are tied to the building, they are effectively prisoners of their landlords.



The real estate industry loved the system, but politicians are finally tiring of playing Uncle Sucker. "In an era of budget scarcity how can you defend a system in which the Government pays more than everybody else?" asks Nicolas P. Retsinas, Assistant Secretary of H.U.D.

But, in this highly partisan era where the Republicans rule in Congress and President Clinton runs the White House, reaching a consensus is never easy. And this problem is tough, because the renegotiation of overpriced subsidy contracts and the conversion of building-specific subsidies to housing vouchers useful anywhere won't get the Government off the financial hook. Mortgages on the subsidized buildings are all federally insured. And while no one knows the exact numbers, it is widely agreed that landlords would default on the great majority if H.U.D. allowed their rental income to fall to competitive levels. Hence from Washington's perspective, Mr. Litan notes, "it's pay now or pay later."

Make that "pay more later," much more. Unless Congress extends building-specific subsidies indefinitely — an implausible outcome in light of the Federal budget crunch — the Government will have to foreclose on hundreds of thousands of occupied units. H.U.D. estimates the foreclosure route would add $5 billion to the cleanup cost.

A tidier, cheaper fix, proposed by the Clinton Administration in 1995, would eliminate building-linked subsidies as the current contracts expire. The Government would voluntarily take a one-time hit by relieving building owners of a portion of their mortgage liability. Meanwhile, tenants in previously subsidized units would get housing vouchers that would give them the option of staying put or shopping for something better.

The Republican Congress took a rain check on serious consideration of the proposal. Instead, it extended expiring subsidy contracts for one year — no big deal since fewer than 1 percent expired in 1996. And it gave H.U.D. authority to restructure the mortgages on a token 15,000 units. But subsidy contracts for 236,000 units expire next year.

Now the Clinton Administration is back with a revised proposal. The plan would pay third parties — including state and local housing agencies — to take over the Federal mortgage liabilities and make the best deals they could with landlords losing their above-market subsidized rents. Uncle Sam would share in any profits associated with hard bargaining. To win over the real estate lobby, the Administration has also signaled that it would not oppose tax breaks for landlords who would otherwise be forced to pay capital gains levies on any savings on their mortgage.

• • •

A bipartisan settlement of so complex and potentially embarrassing a problem along these lines may seem out of reach in a Presidential campaign. But Mr. Retsinas is cautiously optimistic. There is quiet agreement in Congress that future subsidies for affordable housing must be untangled from past errors in housing finance — and at minimal taxpayer cost. "This," Mr. Retsinas says hopefully, "is no longer about ideology."

August 22, 1996

Dana B. Horn
Trustee
DBH Trust
P.O. Box 7607
Riverside, CA 92513

Dear Dana,

Thank you for writing again regarding the Section 8 program and FY 97 appropriations. As I indicated in my June response, this Administration is fully committed to ensuring that we continue to protect and assist vulnerable populations, including our elderly, in this era of constrained federal resources.

To do so, we recognize that we must address the situation caused by expiring Section 8 contracts. The federal government cannot afford to continue funding Section 8 assistance at the current subsidy level. In addition, the distressed condition of parts of the assisted portfolio demands attention. We are working, in consultation with the broad range of constituencies that would be affected by changes in the program, to develop a fair and equitable way to address this complex situation.

The Administration's proposals include a number of protections for residents. A local government could elect to continue project-based assistance for those apartment buildings that require it because of the nature of their tenancy, the location of the projects, or other specific circumstances of the projects. If a local government elected to provide tenant-based assistance, all residents currently assisted through Section 8 subsidies provided to the property, as well as currently unassisted but eligible residents, would be protected through the use of enhanced vouchers and thus able to remain in their existing apartments.

The Administration's proposals also take into account the concerns of property owners and limited partners. The Administration will not abrogate any contracts before their scheduled expiration dates. While existing Congressional authority allows HUD to renew expiring Section 8 contracts that are above market at lower levels, owners will not face defaults. Since FHA is the mortgage insurer of these properties, the federal government will pay to reduce affected mortgages to levels that can be supported by lower Section 8 subsidies. The Administration has also expressed a willingness to work with Congress on legislation that would defer the recognition of taxable income that could result from a debt restructuring. Congress has not yet taken any steps toward providing such legislation.

I will keep your concerns in mind as we work with Congress toward a responsible and proactive solution to the increasing cost of project-based Section 8 assistance that will address budgetary realities and still maintain a commitment to affordable housing for low-income families.

I appreciate hearing from you on this important issue.

Sincerely,

Carol H. Rasco
Assistant to the President for Domestic Policy

fax: 456-7028

TO: Molly Bostrum

FROM: Stephanie Smith

Thanks for asking for comment on the letter to Dana Horn. I've revised somewhat the third paragraph, with a suggested replacement below. Your draft is correct and is an appropriate response. Horn is right that HUD continues to be asked by House and Senate Appropriations staff, minority and majority, for assistance on thinking through ways of addressing the over-subsization of the assisted portfolio in the FY'97 Appropriations bill. You may want to make the point that these actions are being taken only in part as budget-cutting measures. They are also being done because of the distressed condition of the portfolio and the need to reform a housing system that no longer functions well.

Suggested revision to the 3rd paragraph:

The Administration's proposals include a number of protections for residents. A local government could elect to continue project-based assistance for those apartment buildings that require it, because of the nature of their tenancy, the location of the projects, or other specific circumstances of the projects. If a local government elected to provide tenant-based assistance, all residents currently assisted through Section 8 subsidies provided to the property would be protected through the use of enhanced vouchers. These vouchers would also be provided to currently unassisted but eligible residents. These enhanced vouchers would allow all currently assisted and unassisted but eligible residents to remain in their existing apartments.

collection of investors in property – had tax benefit

The Administration's proposal on portfolio reengineering also takes into account the legitimate concerns of property owners and limited partners. The Administration will not abrogate any contracts before their scheduled expiration dates. Congress has provided HUD with authority to renew expiring Section 8 contracts that are above market at lower levels. Owners will not face defaults because FHA is the mortgage insurer and the federal government would pay to reduce affected mortgages to levels that can be supported by lower Section 8 subsidies. The Administration has also expressed a willingness to work with Congress on legislation that would defer the recognition of taxable income that could result from a debt restructuring. Unfortunately, Congress has failed to take any steps toward providing such legislation.

Jan. 96 Congress said renew at existing

Existing law: renew at [illegible] 120% of FMR absent 97 legis

[illegible]

FAX TRANSMITTAL

DATE: 6 May 1996

NUMBER OF PAGES (including this page) 3

TO: Molly Brostrom

FAX NO: 456-7028

COMPANY:

PHONE:

FROM: Jim Park
Executive Assistant to the
Assistant Secretary for Housing-
Federal Housing Commissioner

PHONE: 708-3600

MESSAGE:

SHOULD YOU ENCOUNTER ANY PROBLEMS WITH THIS FAX
PLEASE CALL VANESSA L TRAYNHAM (202) 708-0614 EXT 2108
FAX PHONE NUMBER IS (202) 708-2580

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Mr. Kent W. Colton
Executive Vice President
and Chief Executive Officer
National Association of Home Builders
1201 15th Street, NW
Washington, DC 20005-2800

Dear Mr. Colton:

This responds to your letter of April 19, 1996, in which you express concern with respect to Preservation Letter #2, Section II, Questions 3 and 4 and the answers to each which indicate that the Department of Housing and Urban Development must approve an owner's request to prepay or to terminate mortgage insurance.

Please be assured that the Department did not, in any way, intend to take away the owner's right to prepay. Nevertheless, upon reflection, we can see how the responses may have lead a reader to that conclusion. We will clarify our intent by revising the responses to the afore-referenced questions in Preservation letter #3, which will be issued later this week. The revisions will read as follows.

Q. Must an owner request HUD approval prior to prepayment or termination?

A. No, however, restoration of an owner's right to prepay does not eliminate the need for HUD notification of the owner's intent or the need for HUD review. As part of its normal prepayment/mortgage termination procedure, HUD must assure that there are no outstanding regulatory agreement violations or outstanding audit findings and that it will be made whole in the event that the mortgage is in default or HUD-held. Further, under the Housing Opportunity Program Extension Act of 1996, the Department is required to offer protections to tenants who may be displaced due to prepayments or mortgage insurance terminations.

In order to comply with our statutory mandate, the Department will require that owners use the same 30-day notification period provided for in the note and mortgage with regard to notification of the mortgagee of the owner's intent to prepay, to provide HUD with the information it needs in connection with the tenant protections. HUD will use this notification period, in cooperation with the owners, to ensure that actions relative to tenant protections, are implemented.

Q. What is the process by which a Preservation eligible owner requests prepayment or termination of mortgage insurance?

A. The owner should submit the various components of a prepayment request simultaneously to the mortgagee, HUD, State or local government agencies, and tenants.

The mortgagee will submit the official Form HUD-9807, Request for Termination of Multifamily Mortgage Insurance to the Mortgage Insurance Accounting Staff once the owner has made an official request to the mortgagee to prepay or terminate. The form is signed by both the owner and the mortgagee.

The owner will provide the local HUD Office with the information reflected in Preservation Letter #2, Section II, Q1 and A1 simultaneously with its notification to the mortgagee. In so doing, the owner will provide the information HUD needs to prepare for funding any vouchers or certificates which will be needed once the prepayment and potential rent increases happen.

Thank you for bringing this matter to our attention and we trust that this clarification will satisfactorily resolve it.

Sincerely yours,

Nicolas P. Retsinas
Assistant Secretary for Housing-
Federal Housing Commissioner

- need to a
proactively
address interests of tenants

HUD Proposal - or ~~intro'd~~ currently ? = No legisl this yr

House - pulled - what was it?

Senate - "placeholder" : $10M funds for restructuring demo (Soft Seconds

divide into 2 mtg
probability of
repayment on
2nd -

Status of tax proposals?
no Treas

Official position:

THE WHITE HOUSE
WASHINGTON

Jim Park 5/6

MTM: - no formal leg. proposal on MTM FY 97
- put out position paper → moved away from some of controv'l
e.g. 1) + - based → leave to local govt
2) will only pursue over-mkt props (won't pursue under-mkt)

Ernst & Young did study of HUD's portfolio:
Older props are more over mkt than they expected (almost 1/3 over-mkt) + rehab need substantial
→ means govt has to put substl $ in

= 96 demo authority passed ⇒ $30 M use of credit subsidies - allows us to test on a handful of props

= 97 → nothing: altho renewals assume some sort of MTM engineering - but we don't say how will get there (future)

= Senate → will float proposal in near future - all project-based
"more sellable" ⇒ 90% of FMR (w/ a few exceptions)
- think long term subsidies are sustainable
= House → closer to us - want more mkt-based

THE WHITE HOUSE
WASHINGTON

Preservation – FY97: 0 ⇒
– 96: $624

- Recent controversies
  - pre-pay

Preserv Reform Bill – passed as part of FY96 approps
Legisl → priority to non-profits, etc for resident-controlled
incentives
- restored owners rt to pre-pay
- $-based ass for those displaced
- cheaper way of preserving $ → capital grant (1-shot, not lt obligation)
- priority to residents lost to getting deal done
controlled non-pr incentives
- re-instituted res-contr'd non-pr for period of time – but at some point, will have to allow other n-pr's in

trad'ly owners got hefty Sec. 8 $ + financed renovation (pocketed)

Priority purchasers:
We try to give resident non-profits a head start, but not forever

Jim Park 5/8

THE WHITE HOUSE

WASHINGTON

- To preserve all eligible properties ⇒ $4B
- Jim: Some role for a limited preservation program

- We do support aff'ble hsg devlpt ⇒ thru HOME, CDBG...
- but can't depend on subsidies always being there – reality of long term – at some point,

⇒ Need to be more tools for aff'ble hsg – but can't continue to do thru LT rental assistance

NHC Washington Wire
The United Voice for Housing

A weekly bulletin on housing policy and legislation published exclusively for members of the National Housing Conference, 815 Fifteenth Street, N.W., Suite 711, Washington D.C. 20005. Phone: 202/393-5772; fax: 202/393-5656; e-mail: nhc@nhc.org

May 6, 1996

HUD RELEASES ERNST & YOUNG STUDY OF INSURED MULTIFAMILY PORTFOLIO

Late last week the Department of Housing and Urban Development released the analysis of FHA-insured assisted multifamily housing prepared by the E & Y Kenneth Leventhal Real Estate subsidiary of Ernst & Young, one of the nation's largest accounting firms...Ernst & Young examined 558 properties located in 47 states and the District of Columbia, in an effort to draw some conclusions concerning the physical condition of the properties and predict what may happen if rents were adjusted to market...According to Ernst & Young, 32% of the older assisted housing rents are above market, while 90% of the newer assisted, Section 8 housing rents are in excess of market...The Ernst & Young study concluded that the inventory has in the aggregate $6.9 billion in immediate deferred maintenance and short-term capital needs...Again, according to the study, over 2/3 of the older assisted housing and over half of the newer assisted housing has immediate deferred maintenance and short-term capital needs in excess of $5,000 per unit. (When adding long-term capital needs, Ernst & Young concluded that per unit capital requirements average $9,741.)

Ernst & Young concluded that 74% of older and newer assisted properties can meet debt service requirements, operating expenses and capital needs now, or will be able to do so, if rents were adjusted to market and if all or part of the underlying debt were eliminated...However, the remaining 26% either would have, on the average, $4,900 per unit of unsolved capital needs even after full debt write off, or could not cover operating expenses, irrespective of debt and capital needs.

Ernst & Young gave only limited information about how the study data was compiled...Congressional staff members will be briefed this week...Whether the report has a significant impact on portfolio reengineering legislation currently under discussion depends on how Congress feels about the statistical validity of the report...The Senate Banking Committee's draft "concept paper" describing its "mark-to-market" legislation is still about a week away from being released...A committee hearing on the subject is not likely before late June, after the Senate Whitewater hearings have concluded.

H.R. 2406 SCHEDULED FOR HOUSE FLOOR ACTION THIS WEEK

Likely to be taken up by the full House of Representatives before the end of the week, H.R. 2406 is sponsored by Congressman Rick A. Lazio (R-NY), Chairman of the House Subcommittee on Housing and Community Opportunity...The bill repeals the United States Housing Act of 1937, whose enactment created the federal public housing program...Congressman Lazio's bill would replace existing programs with a system of block grants and give local housing authorities greater flexibility over rent levels and tenant selection...The bill would repeal the Brooke Amendment, which mandates that tenants in public housing cannot pay in excess of 30% of their income in rent...Overall, the House bill is regarded as calling for generally more sweeping changes in public housing policy than S. 1260, which the Senate passed in January.

Congressional appropriators have said that they want to see a public housing bill passed before they mark up the FY 97 VA, HUD, Independent Agencies Appropriations bill...Senate VA, HUD Appropriations Chairman Christopher Bond (R-MO) has scheduled a hearing covering the FY 97 HUD budget for Wednesday, May 8.