

GAO

## Testimony

Before the Subcommittee on Human Resources and Intergovernmental Relations, Committee on Government Reform and Oversight, House of Representatives

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July 30, 1996  
10:00 a.m. EDT

# MULTIFAMILY HOUSING

## HUD's Portfolio Reengineering Proposal: Cost and Management Issues

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to testify before this Subcommittee as it examines the management and cost implications of proposals to reengineer about 8,600 properties from the Department of Housing and Urban Development's (HUD) multifamily rental housing portfolio. These 8,600 properties, which we refer to as the insured Section 8 portfolio, are properties that receive mortgage insurance from HUD through its Federal Housing Administration (FHA) and that receive Section 8 rental subsidies that are tied directly to the properties (Section 8 project-based assistance). Two years ago, we testified at a hearing held by this Subcommittee's predecessor concerning the problems affecting HUD's Section 8 properties, including high Section 8 assistance costs and poor physical conditions at many properties.<sup>1</sup>

Subsequently, in May 1995, HUD proposed a process called "mark-to-market" that was aimed at addressing these and other problems. In early 1996, HUD modified that process in response to stakeholders' concerns and renamed it "portfolio reengineering." This statement is based on previous work we have carried out on HUD's multifamily portfolio and also provides the preliminary results of our work on an assignment relating to HUD's proposals. In addition to providing background information on the insured Section 8 portfolio, this statement discusses (1) the problems currently affecting the portfolio, (2) HUD's plans for addressing these problems, (3) a HUD-contracted study by Ernst & Young LLP that estimates how the properties are likely to be affected by HUD's reengineering proposal, (4) our preliminary assessment of Ernst & Young's study, and (5) issues facing the Congress in deciding how to respond to HUD's proposal. We are also providing observations on HUD's portfolio reengineering initiative.

In summary, we found the following:

- The basic problems currently affecting the insured Section 8 portfolio are much the same as those we discussed 2 years ago—high subsidy costs, high exposure to insurance loss, and the poor condition of many properties. These problems stem from one or more of several basic causes. These include (1) program design flaws that have contributed to high subsidies and put virtually all the insurance risk on HUD and (2) weaknesses in HUD's oversight and management of the insured

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<sup>1</sup>Federally Assisted Housing: Condition of Some Properties Receiving Section 8 Project-Based Assistance Is Below Housing Quality Standards (GAO/T-RCED-94-273, July 26, 1994).

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portfolio, which have allowed physical and financial problems at a number of HUD-insured multifamily properties to go undetected or uncorrected.

- HUD's mark-to-market proposal sought to address these problems and their causes by decoupling HUD's mortgage insurance and project-based rental subsidies and subjecting the properties to the forces and disciplines of the commercial market. The process would allow property owners to set rents at market levels, while HUD would reduce mortgage debt if necessary to permit a positive cash flow, terminate FHA's mortgage insurance, and replace project-based Section 8 subsidies with portable tenant-based subsidies. Although HUD expected the proposal to reduce the costs of Section 8 subsidies, lowering mortgage debt would result in claims against FHA's insurance fund. In response to various concerns about its mark-to-market proposal, in early 1996 HUD made several changes to the proposal but left most of its basic thrust intact.
- During 1995, HUD also contracted with Ernst & Young LLP to obtain up-to-date information on market rents and the physical condition of the properties in the insured Section 8 portfolio and to develop a financial model to show how HUD's proposal would affect the properties. Ernst & Young's May 1996 report on the Department's proposal indicates that the vast majority of the insured Section 8 properties—between 77 and 83 percent—would need to have their debt reduced in order to continue operations. The data also indicate that between 22 and 29 percent of the properties in the portfolio would have difficulty sustaining operations even if their mortgages were totally forgiven. It is important to note that the study's results reflect the provisions contained in HUD's mark-to-market proposal prior to the changes that HUD made to the proposal in early 1996.
- Our preliminary analysis of Ernst & Young's financial model indicates that it provides a reasonable framework for studying the outcomes of portfolio reengineering, such as how many properties will need to have their debt reduced. In addition, we did not identify any substantive problems with Ernst & Young's sampling and statistical methodology. We are still assessing how assumptions used in the model affect its estimates of the effects of portfolio reengineering. Our analysis of the cost data that were developed by Ernst & Young as part of its study but not included in its May 1996 report indicates that the claims costs will be substantial—between \$6 billion and \$7 billion on a present value basis. This amount reflects an average debt writedown of approximately 61 to 67 percent of the insured loans' unpaid principal balances at the time of restructuring for properties whose mortgages need restructuring.
- The Congress will also face a number of other key issues in considering HUD's portfolio reengineering proposal. These include (1) whether rental assistance should be project-based or tenant-based, (2) what protection

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should be given households that could be displaced as a result of reengineering, (3) to what extent FHA insurance should be used for restructured loans, and (4) to what degree the federal government should finance rehabilitation costs.

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## Background on the Portfolio

HUD, through FHA, provides insurance that protects private lenders from financial losses stemming from borrowers' defaults on mortgage loans for both single-family homes and multifamily rental housing properties for low- and moderate-income households. When a default occurs on an insured loan, a lender may "assign" the mortgage to HUD and receive payment from FHA for an insurance claim. According to the latest data available from HUD, FHA insures mortgage loans for about 15,800 multifamily properties. These properties contain just under 2 million units and have a combined unpaid mortgage principal balance of \$46.9 billion.<sup>2</sup> These properties include multifamily apartments and other specialized properties, such as nursing homes, hospitals, student housing, and condominiums.

In addition to mortgage insurance, many FHA-insured multifamily properties receive some form of direct assistance or subsidy from HUD, such as below-market interest rates or Section 8 project-based assistance. HUD's Section 8 program provides rental subsidies for low-income families. These subsidies are linked either to multifamily apartment units (project-based) or to individuals (tenant-based). Under the Section 8 program, residents in subsidized units generally pay 30 percent of their income for rent and HUD pays the balance.

According to HUD, its restructuring proposals apply to 8,636 properties that both have mortgages insured by FHA and receive project-based Section 8 rental subsidies for some or all of their units. Data provided by HUD in April 1996 show that, together, these properties have unpaid principal balances totaling \$17.8 billion and contain about 859,000 units, of which about 689,000 receive project-based Section 8 subsidies.<sup>3</sup> According to HUD's data, about 45 percent of the insured Section 8 portfolio (3,859 properties, 303,219 assisted units, and \$4.8 billion in unpaid loan balance)

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<sup>2</sup>These data do not include "HUD-held" mortgages, which are those for which HUD has paid an insurance claim and is now, in effect, the lender. According to its data, HUD holds mortgages on 1,609 properties that have a combined unpaid principal balance of \$5.4 billion.

<sup>3</sup>For various reasons, HUD chose to exclude from its restructuring proposals properties with project-based Section 8 assistance that was provided under its "moderate rehabilitation" program. HUD estimates that there are about 167 insured moderate rehabilitation properties containing about 16,800 units.

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consists of what are called the “older assisted” properties. These are properties that were constructed beginning in the late 1960s under a variety of mortgage subsidy programs, to which project-based Section 8 assistance (Loan Management Set Aside) was added later, beginning in the 1970s, to replace other subsidies and to help troubled properties sustain operations. About 55 percent of the insured Section 8 portfolio (4,777 properties, 385,931 assisted units, and \$13.0 billion in unpaid loan balance) consists of what are called the “newer assisted” properties. These properties generally were built after 1974 under HUD’s Section 8 New Construction and Substantial Rehabilitation programs and received project-based Section 8 subsidies based on formulas with automatic annual adjustments, which tended to be relatively generous to encourage the production of affordable housing.

There is great diversity among the properties in HUD’s insured Section 8 portfolio, as illustrated by 10 properties that we studied in greater depth as part of our current assignment (see app. I). These properties differ in a number of important respects, such as the amount of their remaining unpaid mortgage debt; the types and amounts of assistance they receive from HUD; and their financial health, physical condition, rents, types of residents served, and surrounding neighborhoods and rental housing markets. These factors can influence the effect that HUD’s or other reengineering proposals would have on the properties.

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## Problems Affecting the Portfolio

The insured Section 8 portfolio suffers from three basic problems—high subsidy costs, high exposure to insurance loss, and in the case of some properties, poor physical condition.

A substantial number of the properties in the insured Section 8 portfolio now receive subsidized rents above market levels, many substantially above the rents charged for comparable unsubsidized units. For example, at one of our case study properties, Universal City in Chicago, Illinois, subsidized rents for the 160 Section 8 units range from \$1,017 to \$1,469 per month compared to estimated market rents that the property could command of \$520 to \$750 per month. This problem is most prevalent in (but not confined to) the “newer assisted” segment of the portfolio, where it stems from the design of the Section 8 New Construction and Substantial Rehabilitation programs. The government paid for the initial development or rehabilitation of these properties under these programs by initially establishing rents above market levels and then raising them regularly through the application of set formulas that tended to be

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generous to encourage the production of new affordable housing. It has become difficult to continue the high subsidies in the current budget environment.

A second key problem affecting the portfolio is the high risk of insurance loss. Under FHA's insurance program, HUD bears virtually all the risk in the event of loan defaults. At one of our case study properties, Onterie Center, also in Chicago, Illinois, HUD insures a \$49 million mortgage and holds another \$26 million in mortgage debt that was assigned to the Department in 1992 because of continuing financial difficulties at the property.<sup>4</sup> A third, closely related problem is the poor physical condition of many of the properties in the portfolio. For example, Ernst & Young estimates that one of our case study properties, Murdock Terrace in Dallas, Texas, has \$5.9 million in immediate deferred maintenance and short-term capital needs. A 1993 study of multifamily rental properties with FHA-insured or HUD-held mortgages found that almost one-fourth of the properties were "distressed." Properties were considered to be distressed if they failed to provide sound housing and lacked the resources to correct deficiencies or if they were likely to fail financially.

The problems affecting HUD's insured Section 8 portfolio stem from several causes. These include (1) program design flaws that have contributed to high subsidies and put virtually all the insurance risk on HUD; (2) HUD's dual role as mortgage insurer and rental subsidy provider, which has resulted in the federal government averting claims against the FHA insurance fund by supporting a subsidy and a regulatory structure that has masked the true market value of the properties; and (3) weaknesses in HUD's oversight and management of the insured portfolio, which have allowed physical and financial problems at a number of HUD-insured multifamily properties to go undetected or uncorrected.

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## HUD's Plans for Addressing Problems With the Portfolio

In May 1995, HUD proposed a mark-to-market process to address the three key problems and their causes by decoupling HUD's mortgage insurance and project-based rental subsidy programs and subjecting the properties to the forces and disciplines of the commercial market. HUD proposed to do this by (1) eliminating the project-based Section 8 subsidies as existing contracts expired (or sooner if owners agreed), (2) allowing owners to rent apartments for whatever amount the marketplace would bear, (3) facilitating the refinancing of the existing FHA-insured mortgage with a

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<sup>4</sup>This property includes commercial space and 594 residential units, 119 of which have Section 8 project-based assistance.

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smaller mortgage if needed for the property to operate at the new rents, (4) terminating the FHA insurance on the mortgage, and (5) providing the residents of assisted units with portable Section 8 rental subsidies that they could use to either stay in their current apartment or move to another one if they wanted to or if they no longer could afford to stay in their current apartment.

Recognizing that many properties could not cover their expenses and might eventually default on their mortgages if forced to compete in the commercial market without their project-based Section 8 subsidies, the mark-to-market proposal set forth several alternatives for restructuring the FHA-insured mortgages in order to bring income and expenses in line. These alternatives included selling mortgages, engaging third parties to work out restructuring arrangements, and paying full or partial FHA insurance claims to reduce mortgage debt and monthly payments.

The proposed mark-to-market process would likely affect properties differently, depending on whether their existing rents were higher or lower than market rents and on their funding needs for capital items, such as deferred maintenance. If existing rents exceeded market rents, the process would lower the mortgage debt, thereby allowing a property to operate and compete effectively at lower market rents. If existing rents were below market, the process would allow a property to increase rents, potentially providing more money to improve and maintain the property. HUD recognized, however, that some properties would not be able to generate sufficient income to cover expenses even if their mortgage payments were reduced to zero. In those cases, HUD proposed using alternative strategies, including demolishing the property and subsequently selling the land to a third party, such as a nonprofit organization or government entity.

After reviewing HUD's proposal, various stakeholders raised questions and concerns about the proposal, including the effect that it would have on different types of properties and residents, and the long-term financial impact of the proposal on the government. In response to stakeholders' concerns, HUD made several changes to its proposal and also renamed the proposal "portfolio reengineering." The changes HUD made included (1) giving priority attention for at least the first 2 years to properties with subsidized rents above market; (2) allowing state and local governments to decide whether to continue Section 8 project-based rental subsidies at individual properties after their mortgages are restructured or switch to tenant-based assistance; and (3) allowing owners to apply for FHA

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insurance on the newly restructured mortgage loans. In addition, HUD stated a willingness to discuss with the Congress mechanisms to take into account the tax consequences related to debt forgiveness for property owners who enter into restructuring agreements. More recently, HUD has also suggested that action should be deferred on properties that would not be able to generate sufficient income to cover operating expenses after reengineering until strategies are developed that address the communities' and residents' needs relating to the properties.

On April 26, 1996, HUD received legislative authority to conduct a demonstration program to test various methods of restructuring the financing of properties in the insured Section 8 portfolio.<sup>5</sup> Participation in the program is voluntary and open only to properties that have rents which exceed HUD's fair market rent (FMR) for their locality.<sup>6</sup> The purpose of the demonstration is to test the feasibility and desirability of properties meeting their financial and other obligations with and without FHA insurance, with and without above-market Section 8 assistance, and using project-based assistance or, with the consent of the property owner, tenant-based assistance. The demonstration program is limited by law to mortgages covering a total of 15,000 units, or about 2 percent of the total units in the insured Section 8 portfolio. An appropriation of \$30 million was provided to fund the cost of modifying loans under the program, which remains available until September 30, 1997. HUD believes that this funding level could limit the number of properties that can be reengineered under the demonstration. On July 2, 1996, HUD issued a public notice announcing the program and providing initial guidance on how it plans to operate the program.

On May 21, 1996, the Senate Committee on Banking, Housing, and Urban Affairs issued a Staff Discussion Paper to outline a general strategy for addressing the problems with HUD's insured Section 8 portfolio. Among other things, the staff proposed to continue project-based Section 8 assistance and to subsidize rents at 90 percent of FMR (or at higher budget-based rents in certain cases if the FMR-based rents would not cover the costs of operation). On June 27, 1996, the Subcommittee on Housing Opportunity and Community Development held a hearing on the staff's

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<sup>5</sup>Authority for the demonstration program was provided in section 210 of HUD's Appropriations Act for 1996 (P. L. 104-134).

<sup>6</sup>HUD annually sets "fair market rents" for each metropolitan and nonmetropolitan area in each state. These rents represent the cost of modest rental units of a given size and are used to compute Section 8 tenant-based rent subsidies.

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proposals, and as of mid-July the Subcommittee was drafting a restructuring bill.

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## Objectives and Results of Ernst & Young's Study

In May 1995, when HUD proposed the mark-to-market initiative, the Department did not have current or complete information on the insured Section 8 portfolio upon which to base assumptions and estimates about the costs and impact of the proposal. For example, HUD lacked reliable, up-to-date information on the market rents the properties could be expected to command and the properties' physical conditions—two variables that strongly influence how properties would be affected by the mark-to-market proposal. To obtain data to better assess the likely outcomes and costs of the mark-to-market proposal, HUD contracted with Ernst & Young LLP<sup>7</sup> in 1995 for a study on HUD-insured properties with Section 8 assistance to (1) determine the market rents and physical condition of the properties and (2) develop a financial model to show how the proposal would affect the properties and to estimate the costs of subsidies and claims associated with the mark-to-market proposal.

The study was conducted on a sample of 558 of 8,363 properties and extrapolated to the total population of 8,563 properties identified by HUD at that time as representing the population subject to its mark-to-market proposal.<sup>8</sup> The sample was designed to be projectible to the population with a relative sampling error of no more than plus or minus 10 percent at the 90-percent confidence level. A briefing report summarizing the study's findings was released by HUD and Ernst & Young on May 2, 1996. It provides current information on how the assisted rents at the properties compare with market rents, the physical condition of the properties, and how the properties are expected to be affected by HUD's proposal as the proposal existed while the study was under way. As such, it is important to note that the study's results do not reflect the changes that HUD made to its proposal in early 1996.

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<sup>7</sup>The study was conducted by the E&Y Kenneth Leventhal Real Estate Group.

<sup>8</sup>Ernst & Young reported that the sample was drawn from a population of 8,363 properties rather than the HUD-identified population of 8,563 properties because of technical and cost considerations. As noted earlier, HUD now believes that 8,636 properties would be subject to portfolio reengineering.

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## Study Confirms Excess Subsidy Costs and Significant Physical Needs at Properties

Ernst & Young estimates that the majority of the properties have assisted rents exceeding market rents and that the properties have significant amounts of immediate deferred maintenance and short-term and long-term capital needs.<sup>9</sup> Specifically, Ernst & Young's study estimates that a majority of the properties—between 60 and 66 percent—have rents above market and between 34 and 40 percent are estimated to have below-market rents. Ernst & Young's data also indicate a widespread need for capital—between \$9.2 billion and \$10.2 billion—to address current deferred maintenance needs and the short- and long-term requirements to maintain the properties. The study estimates that the properties have between \$1.3 billion and \$1.6 billion in replacement and cash reserves that could be used to address these capital needs, resulting in total net capital needs of between \$7.7 billion and \$8.7 billion. The average per-unit cost of the total capital requirements, less the reserves, is estimated to be between \$9,116 and \$10,366.

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## Study Indicates a Significant Level of Debt Restructuring Would Be Needed

Ernst & Young's analysis also indicates that about 80 percent of the properties would not be able to continue operations unless their debt was restructured. Furthermore, for approximately 22 to 29 percent of the portfolio, writing the existing debt to zero would not sufficiently reduce costs for the properties to address their immediate deferred maintenance and short-term capital needs. The study estimates that between 11 and 15 percent of the portfolio would not even be able to cover operating expenses.

The study was designed to use the information on market rents and the properties' physical condition gathered by Ernst & Young, as well as financial and Section 8 assistance data from HUD's data systems, in a financial model designed to predict the proposal's effects on the portfolio as a whole. Specifically, the model estimates the properties' future cash flows over a 10-year period on the basis of the assumption that they would be reengineered (marked to market) when their current Section 8 contracts expire.<sup>10</sup>

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<sup>9</sup>The study defines capital needs as the cost of improvements needed to bring properties into adequate physical condition to attract uninsured market rate financing. Three categories of capital needs are defined: (1) immediate deferred maintenance, the estimated costs to bring all property operating systems up to market conditions and lender underwriting standards; (2) the short-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in 5 or fewer years; and (3) the long-term capital backlog, the estimated costs for the expired life of property systems requiring replacement in more than 5 years.

<sup>10</sup>For properties with more than one Section 8 contract, the model assumes that the property would be reengineered when the contract with the earliest expiration date expires.

The model classifies the loans into four categories—performing, restructure, full write-off, and nonperforming—that reflect how the properties would be affected by HUD’s proposal. Placement in one of the four categories is based on the extent to which income from the reengineered properties would be able to cover operating costs, debt service payments, deferred maintenance costs, and short-term capital expenses. Table 1 shows the results of Ernst & Young’s analysis of how properties would be affected by HUD’s proposal.

**Table 1: Effects of Reengineering on HUD’s Insured Section 8 Portfolio**

<b>Status of loan after reengineering</b>	<b>Percent of portfolio</b>	<b>Costs covered with reengineered cash flows</b>
Performing	17 to 23	Existing debt, operating expenses, all capital needs
Restructure	50 to 58	Restructured debt, operating expenses, all capital needs
Full write-off	11 to 15	Operating expenses and some capital needs but no debt
Nonperforming	11 to 15	Some operating expenses but no debt or capital needs

Note: Capital needs represent immediate deferred maintenance and short-term (5 years or less) capital needs. In addition, the financial model categorizing the loans assumes annual deposits to replacement reserves.

The case study properties we examined reflect the full range of possible outcomes. Ernst & Young’s model concluded that two of the case study properties would fall into the performing category, two were classified in the restructure category, three were full write-offs, and two were classified as nonperforming.<sup>11</sup>

## Model Results Indicate Eventual Section 8 Savings but High Claims Costs

Ernst & Young’s model provides estimates of Section 8 subsidy costs before and after reengineering and the amount of the FHA insurance claims resulting from writing down the properties’ mortgages and addressing deferred maintenance needs, although in a manner that does not conform with budget rules or scoring methodology. The May 2, 1996, briefing report does not present the information gathered in the study on how portfolio reengineering would affect rental subsidy and claims costs. According to the Deputy Assistant Secretary for Operations, HUD Office of Housing, while the Department plans to use Ernst & Young’s cost data in developing future budget estimates relating to portfolio reengineering, it never

<sup>11</sup>One of our 10 case study properties was dropped from Ernst & Young’s sample prior to their final analysis.

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intended that the cost data be included in Ernst & Young's May 1996 report.

In the model, claims costs include the amount of debt reduction needed for the property to sustain operations at market rents and also include funding for some or all of the immediate deferred maintenance and short-term capital needs. However, the claims costs are limited to a maximum of the unpaid principal balance of the loans at the time of debt restructuring. In addition, the claims costs are based on an evaluation of the loan amount the property could support using standard financial underwriting criteria without the continuation of FHA insurance.

Our analysis of these data indicates that, while Section 8 costs would decrease over the long-run, there may be little or no aggregate savings in Section 8 rental assistance costs over the next 10 years if, as the model assumes, all insured Section 8 properties were reengineered when their current Section 8 contracts expire. These data indicate that, for the period fiscal year 1996 through 2005, there may be little difference in aggregate Section 8 costs after reengineering compared with the cost of continuing project-based assistance at current levels:

- If project-based assistance is continued at current levels (including inflation), the costs in present value terms are estimated to be between \$27.2 billion and \$31.0 billion.<sup>12</sup>
- The cost of Section 8 assistance after reengineering is estimated to be between \$26.5 billion and \$29.8 billion.<sup>13</sup>

A primary reason that 10-year Section 8 cost estimates are similar is that the model assumes that projects will be reengineered when their current Section 8 contracts expire. This analysis thus reflects HUD's contractual obligations, which the Department has repeatedly indicated that it will not abrogate. Because many properties with rents below market have expiring contracts during the first part of the 10-year period and thus will be reengineered early in the process, Section 8 costs increase during the early years but then begin to decrease as more projects with rents above market

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<sup>12</sup>These and other total cost estimates contained in our statement are based on a universe of 8,363 properties—the population from which the sample used by Ernst & Young was selected. The estimates contained in Ernst & Young's May 1996 report are based on a population of 8,563 properties. The difference reflects properties that did not have a chance at being included in the sample due to technical and cost considerations. In general, the estimates in our report would increase by about 2 percent if they were applied to 8,563 rather than 8,363 properties. This assumes that the additional properties HUD identified are similar to those in the original population.

<sup>13</sup>Both estimates assume Section 8 costs increase by 3 percent a year. We discounted these costs by 6.75 percent a year to arrive at a present value estimate.

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are reengineered in the later years. In fiscal year 2005, when Ernst & Young assumes that virtually all projects have been reengineered, Section 8 costs are estimated to be between \$1.9 billion and \$2.2 billion a year on a present value basis. The model indicates that annual savings of between \$298 million to \$493 million (between 13 to 19 percent) could be achieved with reengineering compared with the costs of continuing Section 8 assistance at current levels.

However, we note that Ernst & Young's model does not reflect the changes that HUD made to its proposal in early 1996. Some of the changes offer the potential of additional Section 8 cost savings. For example, HUD is proposing to use a proactive approach to portfolio reengineering and hopes that owners will voluntarily agree to go through this process (and terminate the Section 8 contracts) in advance of Section 8 contract expirations. However, it is not clear to what extent HUD will be successful in attracting owners to restructure in advance of the Section 8 contract expirations—or what additional incentives HUD may have to offer to achieve this goal.

In addition, HUD now plans to focus initially on reengineering properties with rents above market. To the extent that portfolio reengineering focuses on such properties, Section 8 savings would increase. For example, Ernst & Young's data indicate that the 10-year Section 8 costs for properties with assisted rents above market would be between \$21.2 billion and \$25.0 billion compared with between about \$18.5 billion and \$21.5 billion if the loans for properties with rents above market were restructured when the Section 8 contracts expire.<sup>14</sup> Furthermore, it is important to note that some savings would result if, as Ernst & Young's model assumes, mortgage interest subsidies are terminated as projects are reengineered. Ernst & Young estimates that without reengineering, mortgage interest subsidies would range from between about \$841 million to \$1.1 billion over the next 10 years (on a present value basis). However, it should be noted that most properties that receive interest subsidies are believed to have rents that are below market.

Regarding the FHA insurance claims costs, our analysis of Ernst & Young's data indicates that FHA claims for mortgage write-downs and deferred maintenance and other capital costs for properties that need mortgage

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<sup>14</sup>All estimates for projects with assisted rents above or below market rents based on the Ernst & Young sample may be misstated because the sample did not contain both types of properties in each of the groups of properties, called strata, from which they sampled. Thus, the estimates assume that none of the 510 projects from three strata containing newer projects had assisted rents below market. The estimates also assume that none of the 372 older projects from two strata were above market.

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restructuring will be substantial. The mortgage balances for properties needing mortgage restructuring—including those in the full write-off and nonperforming categories that would have their mortgages totally written off—would need to be reduced by between 61 to 67 percent. This reduction would result in claims costs against the FHA multifamily insurance funds. According to the data, the 10-year costs of claims paid, on a present value basis, would be between \$6 billion and \$7 billion. If HUD's proactive approach were successful, while Section 8 savings would increase, the claims amounts related to debt write-down could also be higher than indicated in Ernst & Young's study because (1) the loans would be restructured earlier when the unpaid principal balances are higher and (2) the present value of claims occurring in the earlier years would be higher. However, HUD believes that without a proactive approach, owners will disinvest in the properties. Such disinvestment would have an adverse impact on the physical condition, resulting in higher claims costs at a later date.

The claims payments estimated in Ernst & Young's study indicate substantial loan loss rates for the government.<sup>15</sup> For example, portfolio reengineering claims for properties with assisted rents greater than market rents are estimated to be between \$4.8 billion and \$5.8 billion, and the related unpaid principal balances at the time of restructuring are between \$6.9 billion and \$8.1 billion. The estimated loss rate would be between 67 and 75 percent. Table 2 provides claims, unpaid principal balance, and recovery data for the properties subject to portfolio reengineering.

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<sup>15</sup>The loss rate represents the ratio of claims to the unpaid principal balances at restructure dates.

**Table 2: Impact of Portfolio Reengineering on FHA's Insurance Fund, Fiscal Years 1996-2005<sup>a</sup>**

Dollars in billions (present value)			
Relative value of assisted rents before restructuring	Claims	Unpaid principal balances at date of restructuring	Loss rate
Greater than or equal to market rents	Between \$4.8 and \$5.8	Between \$6.9 and \$8.1	67% to 75%
Less than market rents <sup>b</sup>	Between \$1.0 and \$1.5	Between \$2.2 and \$3.1	40% to 51%
<b>Total</b>	<b>Between \$6.0 and \$7.0</b>	<b>Between \$9.5 and \$10.8</b>	<b>61% to 67%</b>

<sup>a</sup>All estimates for projects with assisted rents above or below market rents based on the Ernst & Young sample may be misstated because the sample did not contain both types of properties in each of the groups of properties, called strata, from which they sampled. Thus, the estimates assume that none of the 510 projects from three strata containing newer projects had assisted rents below market. The estimates also assume that none of the 372 older projects from two strata were above market.

<sup>b</sup>This estimate may be misstated because no projects with claims were found among the sampled projects with assisted rent less than market rent from four strata. Thus, the estimate assumes that none of the 985 projects from these strata were projects with assisted rents less than market rents that resulted in claims. The 985 projects included 807 newer and 178 older projects.

## GAO's Assessment of the Model and the Results

We are currently evaluating Ernst & Young's financial model and expect to issue our report late this summer. Our preliminary assessment is that the model provides a reasonable framework for studying the overall results of portfolio reengineering, such as the number of properties that will need to have their debt restructured and to estimate the related costs of insurance claims. In addition, we did not identify any substantive problems with Ernst & Young's sampling and statistical methodology. However, our preliminary assessment of the study indicates that some aspects of Ernst & Young's financial model and its assumptions may not reflect the way in which insured Section 8 properties will actually be affected by portfolio reengineering. Also, some of the assumptions used in the model may not be apparent to readers of Ernst & Young's May 1996 briefing report.

For example, Ernst & Young's assumptions about the transition period that properties go through in the reengineering process may be overly optimistic. During the transition, a reengineered property changes from a property with rental subsidies linked to its units to an unsubsidized property competing in the marketplace for residents. The model estimates that the entire transition will be completed within a year after the first Section 8 contract expires. In addition, the model assumes that during this year, the property's rental income will move incrementally toward stabilization over 9 months. The lenders with whom we consulted on the

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reasonableness of the model's major assumptions generally believed that a longer transition period of 1 to 2 years is more likely. They also anticipated an unstable period with less income and more costs during the transition rather than the smooth transition assumed in the model. An Ernst & Young official told us that the 9-month period was designed to reflect an average transition period for reengineered properties. While he recognized that some properties would have longer transition periods than assumed in the model, he believed that the transition periods for other properties could be shorter than 9 months.

In addition, Ernst & Young's May 1996 report does not detail all of the assumptions used in the firm's financial model that are useful to understanding the study's results. In particular, the model assumes that the interest subsidies that some properties currently receive will be discontinued after the first Section 8 contract expires, including those in the performing category whose debts do not require restructuring. Furthermore, the financial test identifying the loans that could cover all debt service, operating, and capital needs costs if market rents replaced assisted rents, assumes that properties that currently receive interest subsidies would have to pay the full mortgage interest amount without the benefit of the interest subsidy. This assumption would identify fewer performing loans than if the current debt service requirements were tested for. We are currently examining how the assumptions contained in Ernst & Young's study affect its estimates of the effects of portfolio reengineering. In addition, as discussed in appendix II, we also performed sensitivity analyses to assess the extent to which the use of different assumptions affects the results of Ernst & Young's study.

As part of our work evaluating the Ernst & Young model, we also compared Ernst & Young's data on market rents and deferred maintenance with information from the three licensed appraisal firms we retained to assess 10 of the HUD-insured Section 8 properties included in Ernst & Young's sample. In 8 out of the 10 cases, the estimated market rents provided by these appraisers are reasonably close to (i.e., within 10 percent of) the rents Ernst & Young developed in their market surveys. In two instances, however, Ernst & Young's market rent estimates are more than 20 percent lower than the market rent estimates of the appraisal firms. This difference reflects in large measure a different methodology that Ernst & Young used in estimating market rents in neighborhoods consisting primarily of assisted properties—where few, if any, comparable market properties were identified. In these cases, Ernst & Young assumed that since the local neighborhood was essentially maintained by

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non-market driven forces, there was no market for unassisted rents in these neighborhoods other than that controlled by the local housing authority. Thus, Ernst & Young based its rent estimates on the rents subsidized by the local housing authorities. In contrast, the appraisers we retained believed that there were comparable properties that could be used to estimate market rents for the two properties.

While the information we had on the market rents for our 10 case studies was generally consistent with Ernst & Young's estimates, the information on capital needs costs varied widely. In general, the Ernst & Young cost estimates were significantly higher. The appraisers we retained conducted physical inspections of the properties but were not tasked with performing engineering studies. In contrast, Ernst & Young retained a firm to conduct engineering studies at the properties. Officials from Ernst & Young and the engineering firm said the inspections were not full engineering studies which would be used in financial underwriting or negotiations with the owners. However, the inspections provide preliminary data that can be used for budgeting purposes. Because the appraisals conducted for us were more limited in scope than Ernst & Young's reviews and thus not directly comparable, we provided the property owners and managers with the capital needs estimates developed by Ernst & Young and by the appraisers for their evaluation. We are currently examining their responses and the reasons for the differences in the capital needs estimates.

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## Complex Issues Will Shape the Potential Outcomes of Reengineering

The Congress faces a number of significant and complex issues in evaluating HUD's portfolio reengineering proposal. How these issues are resolved will, to a large degree, determine the extent to which the problems that have long plagued the portfolio are corrected and prevented from recurring and the extent to which the restructuring process results in any net savings to the government. Key issues include the following:

- How should HUD's problems in managing the insured Section 8 portfolio be addressed?
- To what extent should FHA insurance be provided for restructured loans?
- Should rental assistance after reengineering be project-based or tenant-based?
- What protection should be given to residents of reengineered properties to protect them from rent increases or displacement?
- To what extent should properties with assisted rents that are below market rents be included in portfolio reengineering?

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- What process or processes should be used to restructure mortgages?
  - To what extent should the federal government finance rehabilitation costs?
  - What actions should be taken to deal with properties that would have difficulty in sustaining operations after portfolio reengineering?
  - Whether and to what extent should tax relief be provided as a part of the reengineering process?
  - Will the current demonstration program be sufficient to test the range of options for carrying out portfolio reengineering and its effects on properties and residents?

These issues are discussed further in appendix III.

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## Observations

HUD's portfolio reengineering initiative recognizes a reality that has existed for some time—namely, that the value of many of the properties in the insured Section 8 portfolio is far less than the mortgages on the properties suggest. Until now, this reality has not been recognized and the federal government has continued to subsidize the rents at many properties above the level that the properties could command in the commercial real estate market.

As the Congress evaluates options for addressing this situation, it will be important to consider each of the fundamental problems that have affected the portfolio, and their underlying causes. Any approach implemented should address not only the high Section 8 subsidy costs, but also the high exposure to insurance loss, poor physical condition, and the underlying causes of these long-standing problems with the portfolio. As illustrated by several of the key issues discussed above, questions about the specific details of the reengineering process, such as which properties to include and whether or not to provide FHA insurance, will require weighing the likely effects of various options and the trade-offs involved when proposed solutions achieve progress on one problem at the expense of another. Changes to the insured Section 8 portfolio should also be considered in the context of a long-range vision for the federal government's role in providing housing assistance, and assistance in general, to low-income individuals, and how much of a role the government is realistically able to have, given the current budgetary climate.

Addressing the problems of the portfolio will inevitably be a costly and difficult process, regardless of the specific approaches implemented. The

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overarching objective should be to implement the process in the most efficient and cost-effective manner possible, recognizing not only the interests of the parties directly affected by restructuring but also the impact on the federal government and the American taxpayer.

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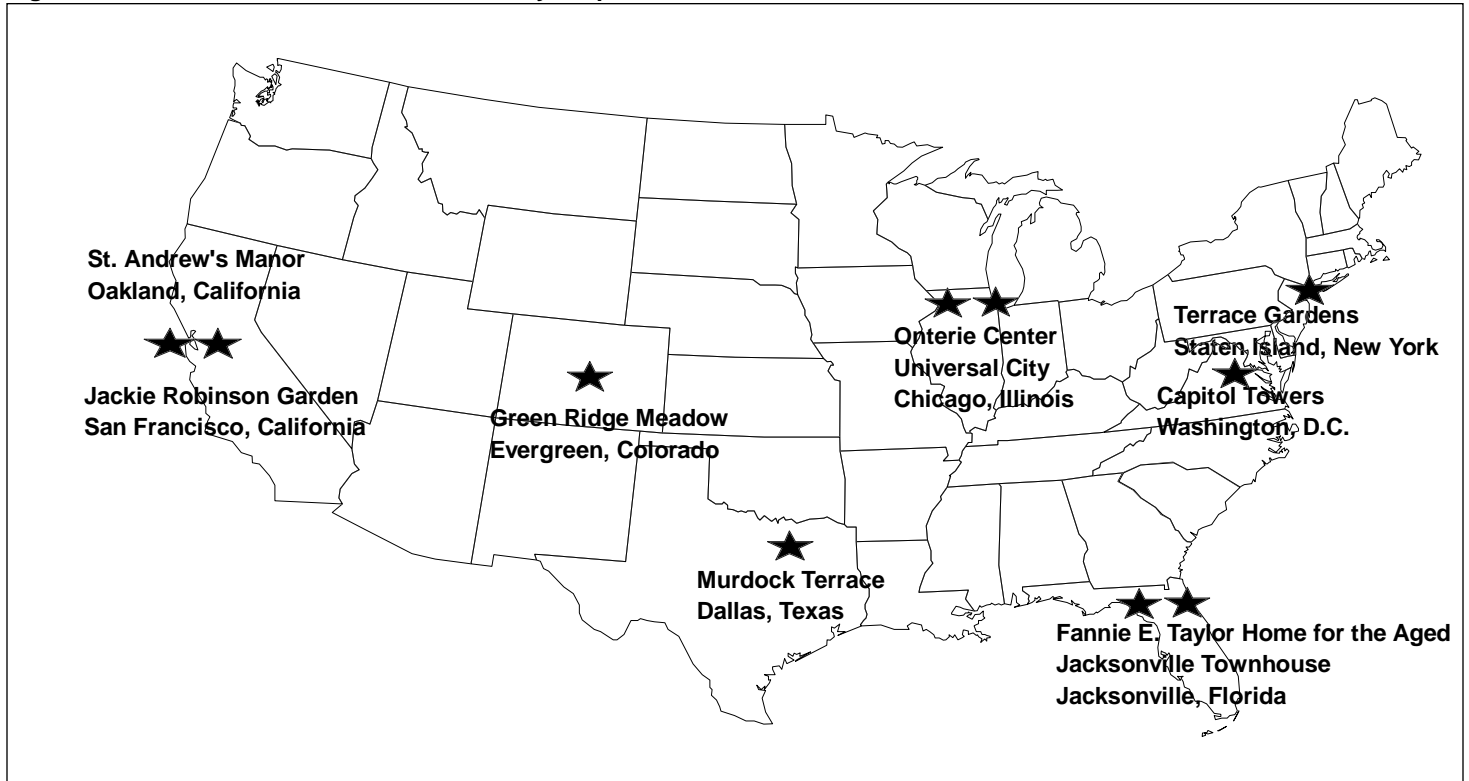
As indicated earlier in our statement, we are continuing to review the results of Ernst & Young's study and other issues associated with portfolio reengineering, and we will look forward to sharing the results of our work with the Subcommittee as it is completed.

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# GAO's 10 Case Study Properties

Figure 1.1: Names and Locations of Case Study Properties



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# Sensitivity Analysis Helps Evaluate the Range of Possible Outcomes

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Any estimates of the outcomes and costs of portfolio reengineering are likely to be subject to some error because they rely on predicting the reactions of numerous owners, lenders, and residents. In addition, as discussed above, we have identified some limitations of the model and some assumptions that may not reflect the way in which insured Section 8 properties will actually be affected by portfolio reengineering. To assess the extent to which the use of different assumptions affects the results of Ernst & Young's study, we performed sensitivity analyses of Ernst & Young's model using two sets of revised assumptions that we developed on the basis of our discussions with multifamily industry officials. One scenario reflects assumptions that are more optimistic in terms of the cost to the government of portfolio reengineering. The other uses assumptions that are more conservative or pessimistic. Both of these sets of assumptions are intended to reflect the range of potential outcomes using the same basic policy assumptions used in the Ernst & Young study. We recognize that the use of alternative policy assumptions can produce different outcomes.

For the optimistic scenario, we used financing terms that the lenders we consulted believed to be the most favorable that were likely to be available, assuming that no FHA insurance or other credit enhancement is provided. For example, we lowered the range of interest rates applicable to the restructured loans from a range of 9.75 to 10 percent to a range of 8.75 to 9 percent. We also revised the debt service coverage ratios, the loan-to-value requirements, and the loan amortization periods to reflect the views of the lenders. In some cases, our terms, though viewed by lenders as optimistic, are more conservative than Ernst & Young's. In addition, a significant difference between our optimistic scenario and Ernst & Young's analysis is that we reduced all capital costs used by Ernst & Young by 25 percent.

For our pessimistic scenario, we used higher interest rates than Ernst & Young, set higher standards for debt service coverage ratios and loan-to-value requirements, and increased the transaction cost and bad debt expense estimates somewhat. We also reduced Ernst & Young's market rent estimates by 5 percent. We did not adjust the capital cost estimates used in Ernst & Young's study for this scenario.

Under all the scenarios, a substantial number of properties are likely to do well, and other properties will have difficulty sustaining operations. Specifically, using optimistic assumptions, between 24 percent to 30 percent of properties fall into the "performing" category, but between 15

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**Appendix II**  
**Sensitivity Analysis Helps Evaluate the**  
**Range of Possible Outcomes**

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percent and 20 percent fall in the two bottom categories—“full write-off” or “nonperforming.” Using the pessimistic assumptions, between 10 and 14 percent would be “performing” and between 39 percent and 46 percent would be “full write-offs” or “nonperforming.” The FHA claims costs associated with portfolio reengineering are estimated to be between \$4.9 billion and \$5.9 billion using optimistic assumptions and between \$8.2 billion and \$9.4 billion using pessimistic ones. The Section 8 subsidy costs are the same as Ernst & Young’s using our optimistic assumptions. Section 8 subsidy costs decrease somewhat using our pessimistic assumptions, where we reduced the estimated market rents by 5 percent.

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# Issues Facing the Congress in Assessing HUD's Portfolio Reengineering Proposal

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The Congress faces a number of significant and complex issues in evaluating HUD's portfolio reengineering proposal. Key issues include the following.

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## How to Address HUD's Problems in Managing the Insured Section 8 Portfolio

One key cause of the current problems affecting the insured Section 8 portfolio has been HUD's inadequate management of the portfolio. HUD's original proposal sought to address this situation by subjecting properties to the disciplines of the commercial market by converting project-based subsidies to tenant-based assistance, adjusting rents to market levels, and refinancing existing insured mortgages with smaller, uninsured mortgages if necessary for properties to operate at the new rents. However, to the extent that the final provisions of reengineering perpetuate the current system of FHA insurance and project-based subsidy, HUD's ability to manage the portfolio will remain a key concern. Thus, it will be necessary to identify other means of addressing the limitations that impede HUD's ability to effectively manage the portfolio, particularly in light of the planned staff reductions that will further strain HUD's management capacity.

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## To What Extent Should FHA Insurance Be Provided for Restructured Loans?

An issue with short-term—and potentially long-term—cost implications is whether HUD should continue to provide FHA insurance on the restructured loans and, if so, under what terms and conditions. If FHA insurance is discontinued when the loans are restructured as originally planned, HUD would likely incur higher debt restructuring costs because lenders would set the terms of the new loans, such as interest rates, to reflect the risk of default that they would now assume. The primary benefits of discontinuing insurance are that (1) the government's dual role as mortgage insurer and rent subsidy provider would end, eliminating the management conflicts associated with this dual role, and (2) the default risk borne by the government would end as loans were restructured. However, the immediate costs to the FHA insurance fund would be higher than if insurance and the government's liability for default costs were continued.

If, on the other hand, FHA insurance were continued, another issue is whether it needs to be provided for the whole portfolio or could be used selectively. For example, should the government insure loans only when owners cannot obtain reasonable financing without this credit enhancement? Also, if FHA insurance were continued, the terms and conditions under which it is provided would affect the government's future costs. Some lenders have indicated that short-term (or "bridge")

financing insured by FHA may be needed while the properties transition to market conditions, after which time conventional financing at reasonable terms would be available. Thus, the government could insure loans for 3 to 5 years, in lieu of the current practice of bearing default risk for 40 years. Finally, the current practice of the government's bearing 100 percent of the default risk could be changed by legislation requiring state housing finance agencies or private-sector parties to bear a portion of the insurance risk.

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### Should Rental Assistance Be Project-Based or Tenant-Based

In addressing the problems of the insured Section 8 portfolio, one of the key issues that will need to be decided is whether to continue project-based assistance, convert the portfolio to tenant-based subsidy, or use some mix of the two subsidy types. On one hand, the use of tenant-based assistance can make projects more subject to the forces of the real estate market, which can help control housing costs, foster housing quality, and promote resident choice. On the other hand, by linking subsidies directly to property units, project-based assistance can help sustain properties in housing markets that have difficulty in supporting unsubsidized rental housing, such as inner-city and rural locations. In addition, those residents who would likely have difficulty finding suitable alternative housing, such as the elderly or disabled and those living in tight housing markets, may prefer project-based assistance to the extent that it gives them greater assurance of being able to remain in their current residences.

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### What Protection Should Be Given to Households at Reengineered Properties

If a decision is made to convert Section 8 assistance from project-based to tenant-based as part of portfolio reengineering, decisions must also be made about whether to provide additional displacement protection for current property residents. HUD's April 1996 reengineering strategy contains several plans to protect residents affected by rent increases at insured properties. For example, residents currently living in project-based Section 8 units that are converted to tenant-based subsidy would receive enhanced vouchers to pay the difference between 30 percent of their income and the market rent for the property in which they live, even if it exceeds the area's fair market rent ceiling. The residents of reengineered properties who currently live in units without Section 8 subsidy would receive similar assistance if the property's new rents require them to pay more than 30 percent of income. Such provisions are clearly important to help limit residents' rent burdens and reduce the likelihood of residents being displaced, but they also reduce Section 8 savings, at least in the short run. The Ernst & Young study's cost estimates

assume that HUD would cover Section 8 assistance costs for existing residents, even if a property's market rents exceed fair market rent levels set by HUD. However, it does not include any costs for providing Section 8 subsidy to residents who are currently unassisted.

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To What Extent Should Properties With Assisted Rents Below Local Market Rents Be Included in Portfolio Reengineering

The decision about which properties to include in portfolio reengineering will likely involve trade-offs between addressing the problem of high subsidy costs and addressing the problems of poor physical condition and exposure to default. On one hand, reengineering only those properties with rents above market levels would result in the greatest subsidy cost savings. On the other hand, HUD has indicated that also including those properties with rents currently below market levels could help improve these properties' physical and financial condition and reduce the likelihood of default. However, including such properties would decrease estimated Section 8 subsidy cost savings. Although HUD's latest proposal would initially focus on properties with rents above market, it notes that many of the buildings with below-market rents are in poor condition or have significant amounts of deferred maintenance, which will need to be addressed at some point.

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What Process or Processes Should Be Used to Restructure Mortgages

Selecting a mortgage restructuring process that is feasible and that balances the interests of the various stakeholders will be an important, but difficult, task. Various approaches have been contemplated, including payment of full or partial insurance claims by HUD, mortgage sales, and the use of third parties or joint ventures to design and implement specific restructuring actions at each property. Because of concerns about HUD's ability to carry out the restructuring process in house, HUD and others envision relying heavily on third parties, such as State Housing Financing Agencies (HFAs) or teams composed of representatives from HFAs, other state and local government entities, nonprofit organizations, asset managers, and capital partners. These third parties would be empowered to act on HUD's behalf, and the terms of the restructuring arrangements that they work out could to a large extent determine the costs to, and future effects of restructuring on, stakeholders such as the federal government, property owners and investors, mortgage lenders, residents, and state and local government housing agencies. Some, however, have questioned whether third parties would give adequate attention to the interests of owners or to the public policy objectives of the housing. On the other hand, with the proper incentives, third parties' financial interests

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could be aligned with those of the federal government to help minimize claims costs.

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**To What Extent Should the Federal Government Finance Rehabilitation Costs**

Who should pay for needed repairs, and how much, is another important issue in setting restructuring policy. As discussed previously, the Ernst & Young study found a substantial amount of unfunded immediate deferred maintenance and short-term capital replacement needs across the insured Section 8 portfolio, particularly in the "older assisted" properties. Ernst & Young's data indicate that between 22 and 29 percent of the properties in the portfolio could not cover their immediate deferred maintenance and short-term capital needs, even if their mortgage debt were fully written off. HUD proposes that a substantial portion of the rehabilitation and deferred maintenance costs associated with restructuring be paid through the affected properties' reserve funds and through FHA insurance claims in the form of debt reduction. Others have suggested that HUD use a variety of tools, such as raising rents, restructuring debt and providing direct grants, but that per-unit dollar limits be set on the amount that the federal government pays, with the expectation that any remaining costs be paid by the property owners/investors or obtained from some other source.

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**How Should HUD Address the Large Number of Properties That Would Have Difficulty Sustaining Operations**

According to Ernst and Young's assessment, between 22 and 29 percent of HUD's insured portfolio would have difficulty sustaining operations if market rents replaced assisted rents. Furthermore, between 11 and 15 percent of the portfolio would not even be able to cover operating costs at market rents. If additional financial assistance is not provided to these properties, a large number of low-income residents would face displacement. While HUD has not yet developed specific plans for addressing these properties, it appears likely that different approaches may be needed, depending on a property's specific circumstances. For example, properties in good condition in tight housing markets may warrant one approach, while properties in poor condition in weak or average housing markets may warrant another. Further analysis of these properties should assist the Department in formulating strategies for addressing them.

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**To What Extent Should the Government Provide Tax Relief to Owners Affected by Portfolio Reengineering**

HUD's portfolio reengineering proposal is likely to have adverse tax consequences for some project owners. These tax consequences can potentially result from either reductions in the principal amounts of property mortgages (debt forgiveness) or actions that cause owners to

lose the property (for example, as a result of foreclosure). We have not assessed the extent to which tax consequences are likely to result from portfolio reengineering. However, HUD has stated that it believes tax consequences can be a barrier to getting owners to agree to reengineer their properties proactively. While HUD has not formulated a specific proposal for dealing with the tax consequences of portfolio reengineering, it has stated that it is willing to discuss with the Congress mechanisms to take into account tax consequences related to debt forgiveness for property owners who enter into restructuring agreements.

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**Will the Demonstration  
Program Cover the Full  
Range of Options and  
Outcomes**

The multifamily demonstration program that HUD recently received congressional authority to implement provides for a limited testing (on up to 15,000 multifamily units) of some of the aspects of HUD's multifamily portfolio reengineering proposal. As such, the program can provide needed data on the impacts of reengineering on properties and residents, the various approaches that may be used in implementing restructuring, and the costs to the government before a restructuring program is initiated on a broad scale. However, because of the voluntary nature of the program, it may not fully address the broad range of impacts on the properties or the range of restructuring tools that the Department could use. For example, owners may be reluctant to participate in the program if HUD plans to enter into joint ventures with third-party entities because of concerns they may lose their properties and/or suffer adverse tax consequences. Another potential limitation on the program is that the funding provided to modify the multifamily loans may not be sufficient to cover the limited number of units authorized under the demonstration program.

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