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Report to the Chairman, Subcommittee on Housing and Community Development, Committee on Banking, Finance, and Urban Affairs, House of Representatives

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RENTAL HOUSING

Implementing the New Federal Incentives to Deter Prepayments of HUD Mortgages

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The Honorable Henry B. Gonzalez
Chairman, Subcommittee on Housing
and Community Development
Committee on Banking, Finance, and
Urban Affairs
House of Representatives

Dear Mr. Chairman:

In response to your letter of December 20, 1989, we present information on the likelihood that owners of low- and moderate-income rental housing stock will seek prepayments of mortgages insured under sections 221(d)(3) and 236 of the National Housing Act. Some of our findings were reported to the Subcommittee in testimony we provided in February 1990 and in subsequent briefings of Subcommittee staff. These findings have already been used to inform the legislation in this area (P.L. 101-625). We publish our work now to ensure that important data issues are considered in the implementation of the new incentives to deter prepayments, as provided in the 1990 legislation.

As agreed with your staff, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing, and Urban Affairs and to the Secretary of Housing and Urban Development. We will make copies available to others upon request.

If you have any questions or would like additional information, please call me at (202) 275-1854 or Robert L. York, Acting Director for Program Evaluation in Human Services Areas, at (202) 275-5885. Other major contributors to this report are listed in appendix V.

Sincerely yours,

Eleanor Chelimsky
Assistant Comptroller General

Executive Summary

Purpose

In the mid-1980s, Members of Congress, housing advocates, and others voiced concern about the potential loss of rental housing for low- and moderate-income families insured under sections 221(d)(3) and 236 of the National Housing Act. Certain owners of these federally insured properties could prepay their mortgages, which could have changed the character of the properties, putting them beyond the means of many low- and moderate-income families. Legislation enacted in 1990 seems to reduce the likelihood that the supply of low-income housing will be reduced due to near-term prepayments. Nonetheless, information about the number of units eligible for prepayments and the interest of owners in prepayment is provided in this report to aid the implementation of the 1990 legislation.

Background

To help families whose incomes were slightly higher than those eligible for public housing, but not sufficient to pay market rents for standard housing, assistance programs were developed in the 1960s that reduced the financing costs for new low- and moderate-income rental housing construction. In return for reduced interest-rate, federally insured mortgages, private owners agreed to rent to low- and moderate-income tenants, with the savings from lower interest payments passed on to the tenants in the form of lower rents. In general, these mortgages were written with 40-year terms, but many owners could choose to prepay them after 20 years. Prepayment generally would permit the owner to convert the property from low- and moderate-income rental housing to other uses, such as market rate rental units or condominiums. Such conversions could leave many families without adequate housing.

Among the reasons some owners might have for prepaying mortgages, in addition to the possibility of higher rental earnings at market rates, was the chance to capture increased equity in their properties. One Boston project, for example, had appreciated in value from $10.5 million to more than $51 million over 20 years. The owners' investment had been only $395,000.

In 1987, Congress authorized the Department of Housing and Urban Development (HUD) to use existing housing subsidy programs such as rent supplements and rehabilitation loans to deter owners from prepaying. In 1990, Congress passed the Low-Income Housing Preservation and Resident Homeownership Act (title VI of P.L. 101-625), which made this authority permanent. The act also encourages—and helps finance—transfers or sales of projects to nonprofit organizations or to

others who agree to maintain them as low- and moderate-income properties. In addition, the act provides for tests that (1) limit the amount current owners may receive in incentives (the federal cost limits test), and (2) provide a basis for denying incentives where market conditions do not justify them (the windfall profits test).

Results in Brief

GAO found general agreement in four studies that, of a total inventory of about 600,000 units, a maximum of about 367,000 units were eligible for prepayment. Those units might potentially require incentive payments or financing assistance under the 1990 act. The studies—conducted while prior law was in effect—show less agreement on the number of units that would probably have been lost through prepayment; estimates ranged from 154,000 to 243,000 units. However, methodological problems in calculating probable losses cloud these estimates in uncertainty. It is not now clear how adequate the estimates are as measures of the demand for assistance under the new legislation; a reasonable assumption is that most eligible owners now will seek preservation incentives. GAO also found problems that have relevance for implementing the new law. Delays in processing applications for prepayments or incentives under the 1987 act occurred in part because field personnel lacked financial expertise and guidance from HUD headquarters. Such delays now could undermine the implementation of the 1990 act because owners may prepay if HUD cannot provide incentives within 15 months after approving a plan of action.

GAO's Analysis

Estimates of Maximum and Likely Losses of Housing

GAO found that even the precise number of properties eligible for prepayment is somewhat uncertain. Instead, policymakers must work with estimates that range from a low of 334,000 family units to a high of 367,000. These uncertainties exist because the four studies GAO reviewed did not use the same procedures in reaching their estimates and, more importantly, because the HUD data bases on which all the studies have relied apparently contain errors that make all estimates somewhat unreliable.

Only two studies attempted to estimate the number of units likely to seek prepayment, and they did not agree. First, based on a 1986 survey of its regional loan officers, HUD estimated that about 154,000 units

probably would be affected by prepayments. However, this estimate is weakened by the study's methodological problems, including missing or erroneous information; failure to survey or interview property owners (who will ultimately make the decision about whether to try to prepay); and substitution of headquarters officials' judgments about local housing markets for those of on-site personnel.

Second, the National Low Income Housing Preservation Commission developed a model to predict whether individual owners would seek to prepay. GAO found that their model provides a useful analytical tool. However, problems weaken their prepayment estimates. These problems, such as the exclusion of important data on noneconomic variables that could affect owners' decisions and model sensitivity to changes in key assumptions, are generally applicable to models of this type. More importantly, the estimates were based on conditions prior to passage of the 1987 and 1990 legislation. To be useful, the model would need to be updated to account for these changes and more current data would need to be collected.

Quality of HUD Data

GAO found that accurate estimates of the scope of the prepayment problem cannot be made because of weaknesses in the data bases maintained by HUD. First, the HUD data contain errors that make it difficult to identify the units eligible for prepayment. Second, the lack of accurate information on the physical and financial conditions of the properties makes HUD data insufficient for estimating the potential costs of incentives to deter prepayments. If these costs were to be higher than expected, the subsidy funds could be drained, impeding the prepayment prevention program and reducing the availability of housing subsidies for other programs. HUD has recognized the weaknesses in its data system and has contracted for a study to develop a more useful data base. While it is premature to assess the results of this study (scheduled for completion in 1992), the sample may be too small to provide information about the volume or costs of prepayment or incentive plans of action taking account of local housing markets.

Local Market Conditions and Owners' Prepayment Plans

GAO found that local market conditions played a major role in owners' plans. Owners interviewed by GAO (before the 1990 legislation was passed) in what were then the high-demand, low-supply markets of Los Angeles and Boston cited three major reasons for wanting to prepay: (1)

the built-up value of their properties, compared to their original investment, made selling attractive; (2) the earnings limit of 6 percent on original investment then allowed under the HUD programs was much lower than the market return would be; and (3) fears of legislative action to "change the rules" discouraged them from continuing to participate in the program. By contrast, the owners in the low-demand, high-supply markets of Denver and Houston reported they did not plan to prepay because: (1) the value of their properties had been stagnant or even declined, so that little gain could be realized by selling; and (2) the subsidies they and some of their tenants obtained from related HUD programs provided them with a steady source of rental income and kept their vacancy rates low.

Recommendations

GAO recommends that in implementing the 1990 act the Secretary of HUD ensure that its regional and field office market economists participate in delimiting the relevant local market areas for the federal cost limits test and in determining whether there is an inadequate supply of decent, affordable housing for the windfall profits test. In addition, GAO recommends that the Secretary (1) enhance staff expertise in real estate finance through hiring, training, and contracting in order to ensure better and more timely negotiation of incentives, and (2) review current guidance to field offices on how to negotiate incentive packages in light of the 1990 legislation, providing better guidance where necessary.

Agency Comments

HUD provided comments on a draft of this report (see appendix III) in which the agency raised two major issues. First, HUD disagreed with GAO's draft recommendation that HUD develop a mechanism to target incentives designed to avoid mortgage prepayments. However, this objection was rendered moot when Congress passed the 1990 act. Second, HUD disagreed with GAO's finding that HUD's field offices often missed time-line requirements in processing prepayment plans of action and that the delays may have resulted from insufficient training and guidance provided by HUD to its field staff. HUD also noted its efforts to provide further training and guidance. The report now notes these efforts but does not change the finding because discussions with HUD staff in all the regions visited by GAO indicated that the training and guidance cited by HUD had not been sufficient to meet their needs. Finally, HUD made a number of other comments. Where appropriate, the report was changed to respond to these points.

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Abbreviations

CBO	Congressional Budget Office
FHA	Federal Housing Administration
GAO	U.S. General Accounting Office
HUD	U.S. Department of Housing and Urban Development
LMSA	Loan Management Set-Aside program
MIDLIS	Multifamily Insured and Direct Loan Information System
MIS	Management Information System

Introduction

In the 1980s, concern grew that the nation's supply of privately owned, federally subsidized housing for low- and moderate-income families would decline sharply within 10 to 15 years, placing at risk the homes of hundreds of thousands of low- and moderate-income families. Some properties were vulnerable because the physical needs of aging buildings far outstripped the income available to renovate them. Other properties faced the termination of previously available subsidies and, as a result, would no longer provide sufficient returns to ensure that their owners would continue to rent to low- or moderate-income tenants. Still others were eligible to be released from commitments that had restricted them to low- and moderate-income use and could have been converted to more lucrative uses if owners chose to prepay mortgages.

In this report, we address this last issue by comparing and examining the soundness of recent estimates of the potential threat to the inventory posed by mortgage prepayments, reviewing the quality of the data available to make these estimates, and presenting new data that link the likelihood of prepayment to the strength of local rental housing markets. We examined the data initially to estimate the potential threat of mortgage prepayments. With congressional action in 1990, this threat is now less immediate, but we show in this report that such data, appropriately updated to reflect changed conditions, are needed to estimate the demand for Department of Housing and Urban Development (HUD) subsidies. If this demand absorbs substantial HUD resources over the long term, the result could be increasing federal housing expenditures that could again threaten the supply of low-income housing. Finally, we describe what HUD did to provide incentives authorized under the Emergency Low Income Housing Preservation Act of 1987 to deter prepayments and the timeliness of the incentive approval process.

A Brief History of Federal Housing Assistance

Federal housing assistance for low-income families began with the passage of the United States Housing Act of 1937. In 1949, Congress established as national housing policy "the realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family." Initially, the federal government had sole responsibility for achieving this goal and authorized state-chartered, public housing authorities to develop, own, and operate low-rent housing projects. The federal government bore the development costs of these projects, and tenants' rent payments covered the operating costs.

To help families whose incomes were slightly higher than those eligible for public housing, but not sufficient to pay market rents for standard

quality housing, other assistance programs were added in the 1960s, primarily intended to reduce the financing costs of new construction. At this time, primary responsibility for the production and operation of the low-income housing projects shifted from the federal government to the private sector. Private lending institutions issued reduced interest rate mortgages, insured through Federal Housing Administration loan guarantees, on structures built for low- and moderate-income tenant occupancy. The lowered interest payments were passed on to the tenants in the form of lower rents.

In addition, in 1965, a rent supplement program was introduced to assist selected groups of very low-income households. The Department of Housing and Urban Development paid the difference between the established rent and 25 percent (later raised to 30 percent) of the family income for the elderly or handicapped, for those moving from substandard units, or for those forced to relocate by government actions or disaster. Under the rent supplement program, owners' use of the properties was restricted, for a 40-year period, to rental to low- and moderate-income households.

Beginning in 1974, many of these rent supplements were replaced by Loan Management Set-Aside (LMSA) contracts available through revisions to section 8 of the 1937 Housing Act. The LMSAs provided subsidies to units in financially troubled projects. These subsidies covered the difference between the amounts tenants were able to afford for rent (a maximum of 30 percent of their income) and the locally established fair market rent.

During the 1970s and 1980s, household-based subsidies were introduced, along with project-based aid, to increase the use of existing housing units. Household-based subsidies pay a portion of the unit's rent on behalf of income-eligible tenants and permit them to live in any existing housing unit that meets HUD's property standards. Two forms of project-based aid exist. The first pays a portion of the tenant's rent on a low-income housing unit. The second provides funds to the owners to help them meet the physical and financial needs of the property. Appendix II summarizes the major federal rental assistance programs for low- and moderate-income families.

Certain 40-year mortgages insured by the Federal Housing Administration (FHA) for low- and moderate-income housing under sections 221(d)(3) and 236 of the National Housing Act could be prepaid after only 20 years. This would allow the owners to convert the housing to

other uses, such as market rate rentals or condominiums. By the middle 1980s, this possibility raised congressional concerns about the potential losses of housing for, and displacement of large numbers of, low- and moderate-income families across the nation.

In the Emergency Low Income Housing Preservation Act of 1987, Congress temporarily addressed this issue by taking action to deter prepayments on an interim basis. This act stipulated that certain HUD-insured mortgages could be prepaid only after the owners had: (1) notified HUD of their intent to prepay, and (2) developed a plan, acceptable to HUD, showing the possible effects of prepayment on low-income families. To approve such a plan of action, HUD had to make a finding that the termination of use restrictions would not materially increase economic hardship for current tenants, or displace them in markets where comparable and affordable housing was not available. It also had to find that the supply of vacant comparable housing was sufficient to ensure the availability of affordable housing and the ability of low- and very low-income and minority households to find such housing. The effect was to place a virtual moratorium on prepayments. In addition, the act authorized HUD to offer incentives based on existing subsidies to deter owners from prepaying. Owners receiving any section 8 LMSA assistance also were required to notify HUD, in advance, of their intent not to renew subsidy contracts. Furthermore, HUD was required to ensure that foreclosed properties retained their low- and moderate-income character in any subsequent disposition and to provide the subsidy necessary to permit occupancy by low- and moderate-income tenants.

Facing the expiration of these provisions in 1990, Congress passed the Low-Income Housing Preservation and Resident Homeownership Act in that year. This legislation revises and makes permanent the features of the 1987 act discussed above, but also includes significant new provisions. For example, the act provides incentives for owners to transfer their properties to qualified purchasers, defined as those who are willing to maintain the low-income affordability restrictions on the properties, giving priority to resident councils, nonprofit organizations, and state or local agencies. In addition, where a project's aggregate preservation rents exceed federal cost limits, the owner must either: (1) accept incentives (to stay in the program or to sell to a qualified purchaser) that do not exceed the federal cost limits; or (2) invoke the mandatory sale provisions, accepting any bona fide offer that does not

exceed the cost limits.[1] If no bona fide offer is made, the owner may prepay and end the use restrictions. Where the preservation rents do not exceed federal cost limits, the owner generally may not prepay, but must accept incentives for continuation of use restrictions or transfer the property to a qualified buyer, who is bound to retain the project as low- or moderate-income housing.

While these provisions are designed to prevent losses of low-income housing because of prepayments, their effectiveness depends on the availability of funds to pay for the incentives or transfer actions outlined in the act. If HUD is unable to provide the agreed-upon incentives within 15 months of approval, or in the case of projects that exceed the federal cost limits test, if no qualified buyer makes a bona fide offer, the owner will be allowed to prepay and terminate the use restrictions. However, in such a case the owner is required to pay 50 percent of the moving expenses for displaced tenants, and tenants could remain in the housing at current rents for 3 years. This emphasizes the need for reliable information on the likelihood that owners will seek prepayment or incentives as a first step in estimating both the size of the problem and the potential costs of implementing the act. It also suggests the need for additional data on tenant incomes, potential moving costs, and possible voucher costs.

Objectives, Scope, and Methodology

Our review objectives were to:

- identify the range of estimates of losses in the section 221(d)(3) and 236 programs as reported in various recent studies;

[1]The aggregate preservation rent is the gross amount needed to cover the cost of debt service on any rehabilitation loan, debt service on the federally assisted mortgage, project operating expenses, and adequate reserves for repairs. In addition, to provide incentives to maintain use restrictions, it includes an amount equal to 8 percent of the preservation equity; for purposes of transfers, it includes the cost of debt service on the acquisition loan. Preservation equity is the preservation value of the property, less any debt secured by the property (in the case of extension of use restrictions) or the outstanding balance of the federally insured mortgage (in the case of transfers). Preservation value is the fair market value of the property based on its highest and best use for residential purposes (in the case of extension of use restrictions) or the fair market value based on highest and best use (in the case of transfers). The preservation rents are used to meet the federal cost limits test, under which HUD first must determine whether the aggregate preservation rents for a project exceed 120 percent of the fair market rent for the market in which it is located. If so, HUD must then determine whether they exceed 120 percent of the prevailing rents in the relevant local market. The relevant local market is an area geographically smaller than a market area established under the Housing Act of 1937 that is a distinct rental market area. The appraisals required for incentives or transfers may be used to define the relevant local market. The intent of this test appears to be to insure that mid-value projects in relatively depressed housing markets do not exceed the federal cost limits test merely because they are located in more affluent submarkets.

- evaluate the technical and methodological soundness of the data and models used in the studies and the strength of the resulting estimates; and
- describe the various incentives HUD has provided to owners to prevent losses in accordance with title II of the 1987 act.

As noted earlier, we initially conducted these analyses to estimate likely losses in low-income housing. Congressional action has seemingly reduced the short-term danger of such losses, but the methods used to make these estimates now might be useful in estimating the demand for federal subsidies to retain properties in the low- and moderate-income housing stock.

To accomplish these objectives, we conducted an information synthesis, found illustrative case studies, and collected data at HUD headquarters and four regions. Specifically, we identified all relevant studies conducted between 1985 and 1989, both published and unpublished, dealing with possible losses to the low- and moderate-income, federally subsidized, private housing inventory. We eliminated from the synthesis studies that did not estimate maximum or likely prepayments. Further, we evaluated the methodological soundness of the remaining studies, based on criteria we developed with a panel of experts. (See appendix IV for a list of our expert panelists.)

We also obtained empirical information on the likelihood of prepayment requests in two types of housing markets: one characterized by high housing demand and low supply, the other by low housing demand and high supply. For each of these types of housing markets, we selected two metropolitan areas in which to obtain data. Based on conditions at the time of our work, the two high-demand, low-supply areas were Los Angeles and Boston; the two low-demand, high-supply areas were Denver and Houston.

In each of the four areas, we interviewed HUD officials and housing experts to gain information about the local housing market conditions and to identify state or local actions that might affect housing losses (independent of federal action). Further, we interviewed HUD regional and field office loan servicers and a sample of property owners in these areas to gather information about likely owner actions under various financial and other conditions. We also interviewed HUD headquarters, regional, and field officials to identify the incentives HUD has used to deter mortgage prepayments. Finally, we interviewed owners who claimed incentives under the 1987 Emergency Low Income Housing

Preservation Act to determine if the negotiation process with HUD was timely and if the incentives owners received were adequate to keep them from prepaying, absent federal restrictions on prepayment.

Strengths and Limitations of Our Methods

The major strength of our study is that it brings together findings from a synthesis of prior studies and empirical information on specific local housing markets. We believe this is stronger information than has hitherto been available for addressing our evaluation questions.

Our work was developed under severe time constraints to allow the findings to be incorporated into the Housing and Community Development Subcommittee's consideration of the legislative changes adopted in 1990. This meant that we could not develop statistically valid estimates of likely low-income housing losses. The data we obtained in two types of housing markets provide some indications of property owners' motivations and actions; however, we were not able to conduct the large-scale study that would have produced nationally representative estimates of owners' plans. But given the variety and volatility of housing markets, making accurate estimates of owners' prepayment actions might not have been possible.

We performed our work between January 1989 and April 1990. Our review was performed in accordance with generally accepted government auditing standards.

Report Structure

Chapter 2 presents the range of estimated maximum and likely housing losses reported by four recent studies and discusses the methodological soundness of the studies and the consequent reliability of their estimates. Chapter 3 presents empirical data collected through illustrative case studies that discuss some factors that might influence low-income housing owners' investment decisions. Chapter 4 describes the incentives HUD used to deter prepayments under the 1987 Emergency Low Income Housing Preservation Act and the timeliness of the process of negotiating with owners. Finally, chapter 5 summarizes our conclusions, presents recommendations for the Secretary of HUD, and presents HUD's comments on an earlier draft of the report along with our response.

Estimates of Losses to the Subsidized Rental Inventory

In this chapter, we discuss the quality of recent studies that attempted to estimate the potential loss of privately owned low- and moderate-income rental housing units that could have resulted in the displacement of low-income families. Here we answer the first two of our three evaluation questions; namely:

- What is the range of estimates of losses in the section 221(d)(3) and 236 programs as reported in various recent studies?
- How sound are these studies in terms of the technical and methodological quality of the data and models used?

Background

During recent years, a number of studies have estimated the extent to which units in the privately owned low- and moderate-income rental housing inventory insured under sections 221(d)(3) and 236 of the National Housing Act might be lost for various reasons. These studies reflected concern that reductions in the low- and moderate-income housing inventory subsidized under the programs could occur because of mortgage prepayments, mortgage defaults, or section 8 opt-outs and contract expirations.

Mortgage Prepayments

Certain for-profit owners of properties insured under sections 221(d)(3) and 236 of the National Housing Act were entitled, on the 20th anniversaries of their mortgages, to prepay them and convert the properties from low-income occupancy to more profitable uses. Some of the low-income tenants might, with the assistance of housing vouchers, be able to continue residing in the converted properties. Moderate-income tenants who did not qualify for housing subsidies, and low-income tenants who were unable to afford rents even with subsidies, might have to seek housing elsewhere.

Mortgage Defaults

In general, mortgage defaults were most likely to occur on properties that were in such poor financial condition that, absent any government intervention, the owners' best economic alternative was to stop making principal and interest payments. While such properties might technically remain in the low-income housing inventory, their financial conditions were such that the new owners, including HUD, faced continued serious cash losses. According to the National Low Income Housing Preservation Commission, although HUD worked with property owners to prevent defaults, it lacked the resources to cope with large increases in the numbers of such troubled properties.

Section 8 Contract Opt-Outs

Contracts issued under section 8 of the Housing Act of 1937, as amended, were renewable, at the owner's option, at each 5-year anniversary of the 15-year contract life for most Loan Management Set-Asides and for certain new construction and substantial rehabilitation projects. In some high-demand markets, owners were choosing not to renew (i.e., opting-out of) these contracts so they could rent to higher income tenants.

Section 8 Contract Expirations

Both project-based (such as LMSAS) and household-based (such as certificates) section 8 subsidy contracts were beginning to expire. In many cases, these rental subsidies had been crucial both to the financial viability of properties and to keeping rents affordable to low-income households.

We focused our work on those properties that were at risk because of mortgage prepayments. The actions Congress took in 1987 and 1990 presumably have made actual losses because of prepayments less likely.

Studies, Estimates, and Methodological Strengths and Limitations

The studies we reviewed used a variety of methods that produced widely differing estimates of the likely loss to the subsidized housing inventory based on a combination of the above causes. In this section, we provide information on the estimates they derived and the methods they used. Even though the prepayment problem now has been addressed legislatively, this review remains important because it raises questions about how much is known about the size of the prepayment problem (i.e., the number of units for which prepayment might be sought) and the potential costs of incentives to deal with it.

The Studies We Reviewed

In conducting this review, we first used standard bibliographic data bases to identify relevant studies, published during the period 1985 through 1989, that addressed the potential loss of low- and moderate-income rental housing. We then asked a panel of experts to validate our selection of these studies and to identify any additional works, published or unpublished, that we should consider.

Through this process, we identified 29 works relevant to our concerns. Of these, only four works presented original estimates of potential losses to the inventory of low- and moderate-income rental housing subsidized under sections 221(d)(3) or 236 of the National Housing Act. Three of

these efforts were conducted by government agencies: GAO, the Congressional Budget Office (CBO), and HUD.[1] The fourth was carried out by the National Low Income Housing Preservation Commission, a private concern financially supported by the National Corporation for Housing Partnerships and the Ford Foundation.[2] The other 25 works derived their estimates from one or more of these four, and therefore, we focused our efforts on them.

The four studies offered differing estimates of the number of federally subsidized low- and moderate-income housing units that were in the inventory and those units that were at risk of loss because of mortgage prepayments. The differences in estimates reflect the fact that the studies were not designed to answer the same questions, did not deal with the same elements of the housing inventory, and did not use the same data collection methods. However, these differences are not always recognized when data from these studies are cited in derivative works, in press accounts of the problem, or by advocates for particular policy options.

Estimated Potential Losses to the Inventory

Two of the studies—CBO's and ours—assumed that all owners would prepay when they could.[3] Both HUD and the Preservation Commission made estimates of the probable losses to be expected from the insured low- and moderate-income housing inventory.[4] Their estimates are lower than the CBO and GAO estimates, which aimed at providing figures on the maximum losses that might be expected.

Table 2.1 shows that the four studies provide a wide range of estimates of the HUD-insured inventory covered by sections 221(d)(3) and 236, ranging from 581,000 to 645,000 units. This results from some technical

[1] Rental Housing: Potential Reduction in the Privately Owned and Federally Assisted Inventory (GAO/RCED-86-176FS, June 16, 1986); The Potential Loss of Assisted Housing Units as Certain Mortgage-Interest Subsidy Programs Mature, Staff Working Paper (CBO, Mar. 1987); and testimony by Thomas Demery, Assistant Secretary for Housing and Federal Housing Commissioner, before the Subcommittee on Housing and Community Development, House Committee on Banking, Finance, and Urban Affairs, Mar. 26, 1987.

[2] Preventing the Disappearance of Low-Income Housing (Washington, D.C.: 1988).

[3] Our study was not designed to estimate actual losses, but to estimate minimum and maximum losses at two points in time: by 1995 and by 2005. A minimum loss of 6,000 units was estimated for 2005, assuming all owners held their mortgages for the full term.

[4] In addition to prepayments, the Preservation Commission estimated that 280,000 units would be subject to defaults, for a total loss from both sources of 523,000 units through 2002. However, HUD argues that defaults do not result in losses because the properties are taken over by HUD and retained in the low- and moderate-income inventory, even when sold, as required in the 1987 act.

differences in how the data were extracted from HUD's data bases and the exclusion of section 221(d)(3) market rate properties from the CBO study. Three of the works, however, had similar estimates of the number of units eligible for prepayment—334,000 to 367,000. (Ours was larger because it included specific for-profit properties with rent subsidies and flexible subsidies whose owners technically could prepay but would still be subject to use restrictions.) The importance of the broad agreement on the number of units eligible for mortgage prepayment is that it provided an approximate upper limit to the scope of the prepayment problem.

Table 2.1: Estimated Mortgage Prepayments Under Sections 221(d)(3) and 236[a]

Housing units	Preservation Commission (1988)	HUD (1987)	CBO (1987)	GAO (1986)
Total	645	604	581[b]	627
Eligible for prepayment	367	364	334	425[c]
Projected prepayments by 2005				
Maximum	[d]	[d]	334[e]	255[f]
Probable	243[g]	154[h]	[d]	[d]
Maximum and probable prepayments as a percentage of total inventory	38	25	57	41

[a]In thousands of units.

[b]Excludes section 221(d)(3) market rate properties because the program does not provide interest rate subsidies and does not impose use restrictions unless the project also is receiving supplementary rental assistance.

[c]Includes some properties that could be prepaid but would still be subject to use restrictions because of rent supplements or flexible subsidies.

[d]Not projected.

[e]CBO estimate is for maximum prepayments by 2001.

[f]GAO estimate is for maximum prepayments by 2005.

[g]Estimate of the National Low Income Housing Preservation Commission is for prepayments by 2002.

[h]HUD estimate is for prepayments "ever," that is until all mortgages reach maturity.

The estimated losses in these programs by early in the next century ranged from 154,000 to 334,000 units. At the high end, CBO estimated that by 2001, all the 334,000 units eligible for prepayment could be prepaid, representing about 57 percent of the total inventory. But the CBO study concluded that

"it is impossible to forecast how many of the 2,900 project owners who are able to end their mortgage-related use restrictions between 1986 and 2001 will do so and,

consequently, how many of the 334,000 units in these projects will actually be lost from the assisted housing stock."[5]

At the low end, HUD concluded that of 364,000 units eligible for prepayment, 84,000 "definitely" would be prepaid and an additional 70,000 "likely" would be for a total of 154,000 units, or about 25 percent of the total inventory. The Preservation Commission's analysis predicted that by the year 2002, a total of 243,000 units (38 percent) would be lost, a figure similar to GAO's estimate of a maximum of 255,000 units (41 percent of the inventory) by 2005.

Quality of the Underlying Data

One issue in assessing the soundness of these estimates is the quality of the underlying data. We found that all four studies used HUD data as the starting point for establishing the number of units in the inventory and the number eligible for prepayment. Therefore, any systematic weaknesses in HUD's data are also contained in the data used to develop each study's estimates as well as other findings and recommendations. The studies use source data from two of HUD's data bases—the Multifamily Insured and Direct Loan Information System (MIDLIS) and the Section 8 Management Information System (Section 8 MIS).

More importantly, weaknesses in its data bases could make it difficult for HUD to plan for handling prepayment or incentive plans of action provided for in the 1990 housing act. For example, key data on local housing markets or tenants are not included, but these variables will be important in determining the volume and costs of federal incentives under the 1990 act.

HUD has, in fact, recognized weaknesses in its data bases. On October 14, 1988, HUD issued a request for proposal to assess HUD-insured multifamily rental housing and to address weaknesses in three of its major data bases, including MIDLIS and the Section 8 MIS. According to HUD, from the standpoint of doing policy research, these data bases have several weaknesses. Many data elements are inaccurate, out of date, or incomplete because they are not used in day-to-day loan servicing. The data bases are massive and require significant effort and time to produce profiles of the inventory that would normally be of greatest value for strategic and policy analysis. Further, according to one HUD study, in

[5]Potential Loss of Assisted Housing Units, p. 16.

addition to the fact that some MIDLIS variables are missing, entered incorrectly, or not current, other problems limit its use for policy analysis. HUD warned that

"since MIDLIS is rarely used by field offices in their regular work, future analysts must exercise caution in relying on this data base, particularly for those property characteristics that may change over time."[6]

In our own work, we also found some errors in the MIDLIS and Section 8 MIS data that were supplemented by field office data to identify properties eligible for prepayment. For example, some properties listed as eligible for mortgage prepayment were in fact owned by nonprofit organizations, which are not eligible to prepay, or owned by for-profit organizations ineligible for other reasons. Thus, reliance on MIDLIS and field office ownership classifications and prepayment eligibility data could lead to an inaccurate estimate of the number of units eligible for prepayment. This would make it difficult to plan for the volume of prepayment plans of action HUD might have to consider or, more importantly, the costs of incentives to deter prepayments.

Because HUD is aware of these problems, the Department has taken steps to provide a study seeking to develop a more useful data base for this type of analysis to be completed in 1992. We interviewed the contractor conducting this study to determine how it will be different from previous efforts. According to the contractor, the study will cover a total sample of 800 properties across all HUD programs. However, fewer than 200 of the sample properties will be eligible for prepayment. As a result, we believe the sample size may be too small to make prepayment or incentive estimates for local markets.

Estimates of the Probable Number of Units at Risk

As shown in table 2.1, only the Preservation Commission and HUD estimated the probable losses that could result from prepayments of mortgages insured under sections 221(d)(3) and 236. In arriving at these estimates, however, the two used very different methods. The Commission's estimates were based on the application of data from a sample of properties to a predictive model, whereas HUD's estimates were developed through a survey of HUD loan service officers.

[6]HUD/FHA-Insured Rental Housing, Physical and Financial Conditions of Multifamily Properties Insured Before 1975 (HUD Office of Policy Development and Research, Apr. 1987), p. 17.

HUD's Testimony

For its congressional testimony presented in March 1987, HUD estimated that about 150,000 units (25 percent of its inventory of section 221(d)(3) and 236 units) likely would be lost because of mortgage prepayments. Further, HUD concluded that the prepayment problem was not a national crisis as was feared by many housing experts, in that the bulk of losses would occur in eight of its field office areas: Los Angeles, San Diego, Boston, Baltimore, Seattle, Dallas, Minneapolis, and Washington, D.C. (The finding that local market conditions are of major importance in determining the scope of the prepayment problem is congruent with our own findings, reported in chapter 4.)

We believe that the method HUD used to make these estimates contains serious methodological flaws. First, HUD directed its loan service officers to judge independently the likelihood of prepayment based on their records and knowledge of the properties. However, in part at least because of time pressures, HUD's study did not include any efforts to learn the views of owners on the extent to which alternative market conditions might influence the decision to prepay. Table 2.2 shows HUD's predictions of probable owner actions.

Table 2.2: HUD Estimates of Likelihood of Mortgage Prepayments

Prepayment likelihood	Projects	Units
Total	5,420	604,460
Ineligible to prepay	2,177	240,906
Eligible to prepay	3,243	363,554
Will definitely prepay	739	84,257
Likely to prepay	622	70,022
Unlikely to prepay	486	52,469
Will not prepay	1,339	150,816
Unknown	57	5,990

Source: HUD testimony, Mar. 26, 1987.

Second, in reviewing the questionnaire used to make these estimates, we found that it lacked questions about many key financial indicators, such as a property's market value and alternative uses, cost data for needed repairs and improvements, and whether the local real estate market and individual property's financial situation is such that conversion costs are not prohibitive. The absence of these questions may reflect the lack of existing HUD data on such items and the short time frame in which to collect such information. The questionnaire did include items concerning other relevant factors such as proximity to downtown or to schools,

parks, libraries, and playgrounds. Questions about negative neighborhood amenities and safety were also addressed.

We also found significant problems with the data that HUD loan service officers used to make their estimates. We interviewed HUD field and regional office loan servicers on selected properties in Denver, Houston, Boston, and Los Angeles. We designed these interviews to learn about the property-specific data HUD field offices have and about how much loan servicers know about their assigned properties. We found wide variation in the amount of property-specific data available from location to location. For example, loan servicers thought some properties were owned by for-profit parties when in fact they were owned by nonprofit organizations ineligible to prepay. Some loan servicers had a significant amount of information about the financial condition of specific properties while others did not. Based on their responses, we believe that loan service officers often lack data on the value of specific properties and have vague ideas of possible alternative uses for properties.

To illustrate the difficulties in making these judgments, we interviewed owners of a sample of properties in Denver, Houston, Los Angeles, and Boston and compared their responses to those of the loan service officers for the same properties. We asked both groups about the physical condition of the sample properties, property values, conversion costs, and whether owners are ultimately likely to prepay their mortgages. HUD responses were generally comparable to those of owners about the physical condition of their properties in Boston, Los Angeles, and Denver. However, in Houston, owners generally thought that their properties were in better physical condition than did loan servicers.

Loan servicers' best guesses as to the current market value and costs to convert to market use (maintenance and renovations) for each property were often far different from what owners perceived as their properties' market value and conversion costs. For example, in Los Angeles, HUD's estimates of property values ranged from 14 percent below to over 100 percent above owners' estimates, and conversion costs for maintenance ranged from 40 percent below to 200 percent over those of owners.

We also found some discrepancies in the numbers reported in the HUD study. For example, HUD's Denver regional office determined that of its 145 properties (12,347 units) eligible for prepayment, as few as 15 (1,182 units) were likely to be prepaid and 79 (7,587 units) were not. Denver's loan servicers responded that they did not know what the

owners' actions likely would be on the remaining 51 properties. However, HUD's 1987 testimony places only 57 properties in the unknown category for the entire nation. This suggested to us that some changes may have been made after data were submitted by HUD regional officials.

To test this conclusion, we checked with the HUD headquarters official who oversaw this survey and found that the estimates reported from the field indeed had been changed. According to this official, the numbers were adjusted based on the assumption that markets change. For example, the Denver market while now "soft" may recover in the future, making mortgage prepayment a more viable option. We agree that markets undoubtedly do change over time, but the direction is not always clear beforehand, and in any case, HUD does not have any documentation showing the methodology used to adjust the numbers provided by its field and regional offices. In addition, the questionnaire that loan servicers completed had three categories of answers: likely to prepay, not likely to prepay, and don't know. We could not determine the methodology HUD used to turn these three response categories into the five categories of prepayment likelihood shown on table 2.2.

Given these methodological shortcomings, we believe that HUD's estimates cannot be regarded as reliable. Using similar methods to plan for the volume or costs of prepayment or incentive plans of action would, therefore, likely be ineffective.

National Low Income Housing Preservation Commission Study

The consensus of our expert panelists was that the Preservation Commission's study was the best available for estimating housing losses. The report built upon a carefully selected sample of HUD properties and used a sophisticated modeling technique to estimate the likelihood that property owners would default or prepay their mortgages under various scenarios. It also provided estimates of the costs associated with various policy options aimed at reducing potential housing losses from the HUD inventory.

Data and Model Used

The data applied to the Commission's model came primarily from HUD records, as well as a survey of a random subset of 300 properties (198 of which were eligible for mortgage prepayment), which were drawn from a sample of section 221(d)(3) and 236 projects used in an April 1987 HUD study.[7] The Commission's report stated that it used a subset of HUD's

[7] HUD/FHA-Insured Rental Housing.

sample because systematic estimates of repair needs were available from no other source than the HUD data base. HUD had used a sample of 477 properties drawn from the older portion of the HUD/FHA multifamily rental inventory insured before 1975. Thus, as a sub-sample, the Commission's sample included properties closer to the date of possible prepayment than a random sample of all properties would have produced. (But the Commission concluded that this sample was adequate for modeling purposes. The sample was weighted to reflect regional factors.) Table 2.3 shows the number of properties and units included in the Commission's sub-sample, by program.

Table 2.3: Preservation Commission Sample

Program	Number of Properties	Units
Section 221(d)(3): Market Rate	34	5,559
Section 221(d)(3): Below Market Interest Rate	72	5,921
Section 236	194	21,642
Total	**300**	**33,122**

The Commission divided its sample of properties into three distinct classes: (1) nonprofit owners ineligible to prepay and obligated to maintain their properties as subsidized housing for the entire 40-year term of the mortgage; (2) for-profit owners ineligible to prepay and obligated for various reasons to maintain their properties as subsidized housing for the 40-year term of the mortgage; and (3) for-profit owners eligible to prepay their mortgages after 20 years.

In the three ownership categories, 66 properties (7,847 units) had nonprofit owners and were ineligible for prepayment, and 36 (4,475 units) had for-profit owners legally ineligible to prepay. The remaining 198 properties (20,800 units) had for-profit owners eligible to prepay.

The Commission's study used an economic and finance analysis to predict owners' actions. The model assumed throughout that for-profit owners would elect whichever option is worth the most (or costs the least) in terms of the discounted present value of the stream of future after-tax returns through the point of sale. Further, the model predicted the point at which it would be to the owners' economic advantage to prepay and convert to a market option. Owners' options included market rate rental, condominium conversion, or conversion to nonresidential use. (For nonprofit owners, the model estimated likely defaults.)

The Commission also collected market data for each of the sub-sample properties through telephone interviews with experts in the local housing market. Those contacted included HUD field office staff, local planning officials, real estate brokers, and appraisers. The respondents were asked to provide their best estimates of the most likely alternative use of the property, were it not to continue as assisted housing, and to estimate its likely market value, in terms of gross rents obtainable in the local market, condominium sale value, or value as a nonresidential property.[8]

The report, however, did not indicate the response rate from the 198 property owners and managers eligible to prepay; it did imply that some did not respond. To fill in data gaps for nonrespondents, the Commission obtained information from HUD on tenant and financial characteristics and correlated this information with industry data. The staff also asked local real estate experts and local government staff in each community for data about market conditions and government-sponsored low-income housing programs.

Strengths and Limitations of the Model

The model was designed to provide overall national estimates of possible prepayments. The major strengths of the model are that it can be used to analyze complicated relationships among a large number of related financial and market variables that could affect mortgage prepayment decisions. Further, the model makes explicit assumptions about trends that permit sensitivity analysis and provide a basis for evaluating the quality of the estimates it generates. It also might provide the basis for estimating the volume and costs of actions under the 1990 act, with further development.

The common limitations of this type of model relate to the underlying assumptions and the quality of the data used. For example, the sample size for this study was limited to 300 observations for all three categories of ownership. Of these 300 properties, only 198 were for-profit and eligible for prepayment. As the study notes, this sample size is too small to permit information on specific markets to be analyzed—a major limitation given the sensitivity of real estate decisions to local market conditions, as we discuss in chapter 3.

Second, while the model examines the economic behavior of owners, it is not designed (as the study notes) to take into account other influences

[8]Local experts indicated that more than 90 percent of the for-profit properties eligible for prepayment would continue as rental properties, most at rents of $400 a month or less.

on owners' decisionmaking, such as major changes in local real estate markets, local politics, owners' concerns about the effects on tenants, risks inherent in changing the character of the property, and imperfect financial information.

Third, the model shows some sensitivity to assumptions about parameters, a limitation common to most such models. For example, when the rental inflation rate over 15 years is assumed to be zero, rather than 5 percent, the estimated number of units lost through prepayments drops from about 243,000 to about 131,000, or 23,000 fewer than HUD's estimate of 154,000. Given that increases in rents may be zero, or even negative in some markets, this is a limitation on the model's predictive utility. However, the study notes that varying assumptions on most other parameters did not have major effects on the estimates and that conditions such as a zero rate of rental inflation are unlikely to persist for 15 years.

Despite these limitations, ongoing modifications of the Preservation Commission's model may prove useful in providing estimates of the volume and potential costs of prepayment requests and the costs of incentives to deter prepayments. Such modifications could focus on changes designed to permit estimates of the amount of preservation equity in the projects, the number of projects likely to stay in the programs versus the number likely to be sold to new qualified owners (since the costs likely will differ in these two situations), and the number that may be denied incentives under the windfall profits test.

Factors That Influence a Decision to Prepay in Two Types of Housing Markets

In chapter 2, we discussed the difficulty of estimating future mortgage prepayment behavior when key data are unknown or erroneous and when the conditions under which decisions are made vary sharply across time and place. Given these problems, we did not develop our own estimates of probable prepayments. Rather, we collected empirical data in two diverse types of housing markets about why owners might choose to prepay their mortgages; we identified types of markets where prepayment actions were most likely to occur; and we solicited from owners information on what incentives might deter their prepayment efforts.

Our basic question was whether owners' expected decisions to prepay federally insured mortgages were strongly related to local housing market conditions, which are principally influenced by factors such as vacancy rates and appreciated property values. Based on the recommendations of housing experts, we chose the metropolitan areas of Los Angeles, Boston, Denver, and Houston for our analyses. The first two were, at the time of our study, housing markets characterized by relatively high demand and low supply; the latter two by low demand and high supply.

We gathered information from owners of federally insured low-income properties in these areas to answer the following questions on low- and moderate-income housing:

- What key factors motivate an owner to invest?
- What are the advantages and disadvantages of mortgage prepayment?
- What incentives are required to discourage mortgage prepayment?

We selected a judgment sample from HUD's MIDLIS files of properties eligible for prepayment of federally insured mortgages by no later than September 30, 1994, approximately 5 years from the time of our interviews. We chose this date in the belief that owners of these properties, who are nearer the date of decision on prepayment, may well have given greater consideration to prepayment than owners with later eligibility dates.

We obtained information on 51 properties (8,603 units); 24 had mortgages insured under section 221(d)(3), and 27 under section 236. We interviewed owners of 30 of the 51 properties in the four cities. Nine of the properties were located in Los Angeles (about 6 percent of those eligible in Los Angeles), 10 in Boston (about 60 percent), five in Denver

(about 60 percent), and six in Houston (about 50 percent). The interviews were intended to be illustrative; we did not have the time necessary to do a survey that could provide nationally representative estimates of owners' prepayment plans.

We also interviewed HUD loan servicers to supplement owner responses. We compared the responses of the two groups to determine how closely HUD's predictions matched the owners' intentions and whether owners' and HUD's opinions were similar regarding the current market value and physical condition of the properties.

Profiles of the Sample Housing Markets

To assess the impact of market forces on owners' investment decisions, our case studies included an examination of the local housing markets for each of the four areas. We gathered data for each of the cities about the past, present, and forecasted condition of the local economy, overall vacancy rates, and individual property market values.

Though the four markets can be separated easily into two groups according to housing supply and demand, our data show that significant differences exist among them. Within each market and from one neighborhood to the next, property values and vacancy rates fluctuate significantly. Table 3.1 shows the average vacancy rate for each market and the appreciation (or depreciation) rates for sample properties in each illustrative case study area.

Table 3.1: Housing Market Characteristics

	Average rate of	
Market	**Vacancy**[a]	**Appreciation**[b]
Los Angeles	2.1%	243.0%
Boston	3.5	400.4
Houston	16.2	−2.5
Denver	11.0	37.2

[a]The source of vacancy rate data was the HUD regional offices of economic and market analysis. The dates for the vacancy rates are as follows: Los Angeles, Mar. 1988; Boston, May 1990; Houston, Jan. 1990; and Denver, May 1989.

[b]The appreciation (or depreciation) rates were calculated using the original property value at time of construction approximately 20 years ago and the accumulated appreciation/depreciation owners claimed at the time of our interviews as the current value of their properties.

Average appreciation rates vary greatly from one metropolitan area to another. The low-supply, high-demand housing markets represented by Los Angeles and Boston were characterized by low vacancy rates and

high levels of appreciation. The high-supply, low-demand housing markets of Denver and Houston had high vacancy rates and low or negative levels of appreciation. In tight markets, properties have appreciated to the point that owners are viewing potential windfall profits. But in soft markets, owners are often faced with depreciating property values and few financial options.

Los Angeles

The Los Angeles market, though showing signs of softening, remained tight at the time of our data collection, and relatively few units were available for low- and moderate-income families. Approximately 31,550 multifamily building permits were issued in Los Angeles County during 1988, down 36.4 percent from the 1986 peak when 49,600 were issued. According to a May 1989 HUD Economic Intelligence Report from the Los Angeles Office of Economic and Market Analysis, for the period 1984 through 1988 (the latest data available),

> "the housing market in Los Angeles County, which has remained tight for well over a decade, has finally begun to show signs of loosening with the overall vacancy rate rising three-tenths of a percentage point to 2.1 percent in March 1988 (up from the 1.5-1.8 percent reported for the 1984-1987 period.)"

According to HUD, the multifamily sector of the market has softened more than the single-family sector; the vacancy rate rose five-tenths of a percentage point to 3.1 percent in March 1988.

During our visit to Los Angeles in November 1989, we observed a sample of the low-income properties and concluded that they were generally located in what appeared to be strong markets and desirable neighborhoods. Most of the projects were surrounded by single-family homes and condominiums and provided access to schools and shopping. These types of neighborhoods typically may offer owners more profitable alternative uses for their low-income properties.

Even in strong markets, however, there are exceptions. For example, one property we visited was unlikely to have other potential uses because, according to the owner, the local neighborhood was crime ridden and drug infested. We observed that many of the units were either boarded up or uninhabitable and that graffiti covered the walls of the entire project. And the single-family homes that were nearby had heavily barred windows. The owner of this low-income project said its marketability was severely limited by crime and local gang activity.

Not far from this property, we observed another low-income project that appeared to be one of the better maintained of those we visited. Moreover, the condition of this property was as good as or better than that of owner-occupied homes and rental properties in the area. It appeared this property could be converted to market use. The owner had applied for incentives under the 1987 act, and the local government had offered tax breaks and other incentives to prevent mortgage prepayment.

Boston

Like the Los Angeles housing market, the Boston market, though tight, has shown recent signs of softening. But we found that during our visit, the demand for low- and moderate-income housing continued to outstrip supply. During the past 5 years, rent increases have averaged 8 to 12 percent annually throughout the region. Furthermore, multifamily housing is difficult to construct in many areas of the region because of permit procedures, land costs, environmental hurdles, and a scarcity of land to develop. These factors increase developers' initial costs and have consequently lowered the number of rental housing units being developed. According to HUD,

> "vacancy rates for rental housing in the larger urban areas of New England are tending to zero in a functional sense. Few rental units are available in southern New England at any cost. Throughout this section the rental vacancy rates range from 2.0 percent to 4.5 percent."[1]

HUD's Boston regional economist and market analyst stated that the multifamily housing market there was stable overall, with a vacancy rate of about 3.5 percent as of May 1990. This market is one in which prices steadily escalated until about 1988, when they began to level off. Because of the concern for potential displacement of low-income families, Massachusetts has taken action to discourage mortgage prepayment and is very active in the low-income housing market. For example, according to HUD officials, the state has enacted legislation (which now may be preempted under the 1990 act) that requires low-income housing owners to seek state-sponsored incentives before prepaying mortgages. The state also provided rent supplements (section 8 funds) to allow owners market rates for rental units, low-interest loans for weatherization and repairs, and state tax incentives.

[1]HUD's Boston Regional Office of Economic and Market Analysis report, Economic and Housing Market Conditions in New England, based on data through the end of 1988.

Denver

According to HUD's Denver regional economist, the outlook for the Denver metropolitan area housing market as of May 1989 remained soft. Some regional improvement has occurred; however, the major market areas face a surplus of both sale and rental units as a result of ambitious building activity during 1983 and 1984 followed by employment losses in 1986 and 1987. The problems of the oil and gas industry were the major contributors to this decline, although significant cutbacks also occurred in coal and metal mining.

The subsequent out-migration left the Denver housing market with a serious oversupply. The apartment vacancy rate peaked at 13.9 percent in late 1986 and has not dipped below 10 percent since the third quarter of 1985. The high vacancy rates of the past few years and the subsequent competition for tenants have brought about widespread rent reductions and concessions. Vacancies likely will remain high in the immediate future, but continued market improvement could bring the vacancy rate below 10 percent.

HUD officials stated that because of the high vacancy rates in this soft market, adequate housing is available at reasonable cost for low-income families. We observed a sample of Denver low-income properties in August 1989 and found that they were generally in good condition and comparable to local market-rate units. However, many of these projects depended heavily on federal subsidies to provide the income needed for maintenance and repairs.

Houston

HUD market economists for the Fort Worth region, which includes Houston, consider the Houston market soft. Overall apartment vacancy rates in the area were 16.2 percent at the beginning of 1990. Many properties rent at levels considerably lower than what is needed to cover operating expenses. Consequently, numerous properties are financially overburdened and are being foreclosed or are in great need of repair.

During our visit to Houston in the fall of 1989, we observed conditions that confirmed the opinions of the Fort Worth HUD economists. While many of the low- and moderate-income projects appeared decent and sanitary, others were in great disrepair. We observed that significant numbers of units in many projects were boarded up or uninhabitable. According to HUD officials, the greatest threat to Houston properties was not mortgage prepayments but disrepair (and subsequent uninhabitability) stemming from insufficient rental income.

Potential Prepayments: Owner Responses

Across both types of markets, we found that owners had similar reasons for both investing and disinvesting in low- and moderate-income housing. The primary reasons owners gave for investing were the financial benefits of a low-interest federally insured mortgage, tax benefits, and the public-spirited or charitable desire to help provide housing for low-income families. In addition to these motivations, the owners invested to make a profit. Some owners insisted they had met their obligation to provide housing for low-income families and had a right to prepay the 40-year mortgages at 20 years, taking advantage of favorable market conditions.

We found that virtually all of the owners we interviewed in the low-supply, high-demand markets wanted to prepay their HUD-insured mortgages when eligible or sell their properties. Of the 19 properties examined in Los Angeles and Boston, only two had owners who stated they intended to continue operating the properties as low- and moderate-income housing. HUD loan servicer responses supported these findings. The loan servicers estimated that only three of these properties would probably continue to be used for low- and moderate-income housing once owners were eligible to prepay their mortgages.

Conversely, of the 11 properties examined in Denver and Houston, none of the owners who responded intended to prepay and convert their properties to market rate rentals. We found that owners in these high-supply, low-demand markets intended either to sell or to continue to operate their properties as low- and moderate-income housing, even after they were eligible to prepay the mortgage. Again, HUD loan servicer responses supported the owners' stated intentions.

Reasons to Prepay in Low-Supply, High-Demand Markets

Owners in the Los Angeles and Boston markets listed three principal factors that could influence a decision to prepay. First, they cited access to perceived built-up equity based on appreciated property values over the past 20 years. Second, they indicated a desire for rates of return greater than those currently authorized by HUD. Finally, owners claimed that they would like to prepay because of uncertainty about legislation.

Increased Market Value of Properties

Many owners in these tight markets reported that they planned to prepay their mortgages to gain access to increased property values or built-up equity. After prepaying, owners could sell the properties, take out equity loans, or convert their properties to higher market uses.

High levels of appreciation exist in both markets. In Boston, the increased values of the sample properties ranged from about 290 to about 679 percent and averaged about 400 percent. For example, one Boston property increased 384 percent, from $10.5 million to more than $51 million over a 20-year period, based on an original investment of $395,000. This increased market value was so great that although the owner estimated it would cost more than $600,000 for general maintenance and repairs and more than $1.8 million for property renovations and upgrades, that owner still intended to prepay the mortgage and convert the property.

In Los Angeles, the appreciation rates generally ranged from 100 to 433 percent, with one atypical project at 16.7 percent. Moreover, 18 of the 19 owners we interviewed in Boston and Los Angeles said that, considering potential profits, even substantial repair and renovation costs would not prevent mortgage prepayment and property conversion. The remaining owner, in Los Angeles, reported that crime and gang activity rather than market factors restricted the property's value and would prevent conversion.

Limited Return on Investment

Several Los Angeles and Boston owners stated that contractual obligations associated with HUD-insured loans limited their ability to realize a higher rate of return on investment. These owners complained that the 6-percent rate of return on original investment allowed under HUD programs at the time of our study had not kept pace with inflation. Moreover, many of these owners told us that they wanted to prepay their mortgages because they were being taxed on income that they did not actually receive. This could occur because many owners with older mortgages have exhausted depreciation allowances to offset rental income in excess of the amount they are permitted to retain under the limited dividend provisions. This condition is commonly referred to as "phantom income." (See the glossary.)

Legislative Environment

Many owners told us that they would not invest in low- and moderate-income housing because of the uncertain legislative environment at the time of our interviews. They contended that Congress, through the 1987 Housing Act, unilaterally had removed their contractual right to prepay their HUD-insured mortgages. For example, one owner stated that because of this precedent, it was difficult, if not impossible, to find new private investors for low- and moderate-income housing.

Factors Working Against Prepayments

Local political restrictions and concern for tenants facing displacement were among the factors that owners in Los Angeles and Boston reported as reasons not to prepay and convert their properties to market uses. For example, one owner in Boston told us that city officials made it clear that they would use all the powers at their disposal to prevent prepayment and possible displacement of tenants. This owner also expressed concern about potential lawsuits by tenants and low-income housing advocates. As a prominent Massachusetts developer concerned about future business in the state, the owner chose to sell two of his properties to a nonprofit organization at significantly less than the appraised market value rather than prepay the mortgages and convert the properties.

Moreover, any owner choosing to prepay incurs the greater market risks inherent in a competitive rental market. These risks include the potential for higher vacancies when subsidies are lost as well as possible fluctuations in local housing market conditions.

Incentives That Might Deter Prepayment

Los Angeles and Boston owners listed a variety of incentives necessary to induce continued ownership of low- and moderate-income housing. These included rates of return greater than HUD's 6-percent limit on original cash investment then applicable, rents increased to fair market levels, and additional subsidies such as section 8 LMSA payments (which pay the difference between 30 percent of tenants' incomes and locally established fair market rents, thereby providing owners rental incomes comparable to market returns).

In addition, owners considered equity take-out loans an effective incentive to discourage mortgage prepayment. According to many owners, equity take-out loans were more attractive than outright prepayment and property sales because capital gains tax liability is deferred and the owner gains access to built-up equity. However, the interest on these loans is not tax deductible. In any case, tenants' rents would need to increase and further federal subsidies would be needed to cover owners' additional debt service associated with increased mortgage payments in cases where equity take-out loans are approved.

Why Owners Would Not Prepay in High-Supply, Low-Demand Markets

Owners in Denver and Houston were confronted by stagnant or decreasing property values, and higher vacancy rates and lower rents in these high-supply, low-demand markets. As a result, low- and moderate-income housing owners in these areas were less likely to plan to prepay

HUD-insured mortgages than were those in Los Angeles and Boston. The owners were likely to report that they planned to continue their mortgages in force because they were sheltered from adverse economic conditions in that occupancy rates and rents remained steady and were not greatly affected by market fluctuations.

Stagnant or Decreasing Property Values

According to the data provided by low- and moderate-income property owners in Denver and Houston, property values have not increased at the significant rates claimed by Los Angeles and Boston owners in the approximately 20 years since these properties were constructed. (See table 3.1 on p. 27.) Data obtained from the Denver owners reveal that property values increased at an average rate of about 37 percent, far less than the 400-percent average rate for Boston or the 243 percent for Los Angeles. Moreover, data provided by Houston owners show that average property values declined by about 3 percent, and in one instance, the value of a Houston owner's property depreciated by 82.8 percent. This owner originally invested a little more than $120,000 on a mortgage of approximately $2 million; the property value was only $380,000 at the time of our survey. For the Houston market, overall, appreciation rates ranged from a negative 83 to a positive 51 percent. In Denver, appreciation rates ranged from a negative 1 to a positive 124 percent.

Given general rates of inflation over the past 20 years, even the highest of these appreciation rates actually is negative in real dollar terms. Thus, these properties do not provide the equity-based incentive for mortgage prepayment and subsequent sale or conversion found in Los Angeles and Boston. Moreover, this suggests that equity take-out loans would not be needed (or effective) to deter prepayments in the Denver or Houston markets.

High Vacancy Rates and Guaranteed Rents

As shown in table 3.1, vacancy rates for Houston and Denver were 16.2 and 11 percent, respectively. According to HUD's Denver market economist and analyst, such high vacancy rates promote a competitive rental market characterized by rent reductions, discounts, and other concessions to attract tenants. Consequently, low- and moderate-income families living in these "soft" markets are less threatened by the scarcity of adequate housing and high rental costs. This also means that owners have little incentive to prepay mortgages and convert their properties to market rentals or other uses.

Moreover, for many of these owners, the current arrangement provides virtually guaranteed rents. Of the 11 owners interviewed in Denver and

Houston, eight (73 percent) stated that they received section 8 LMSA funding. We found that the average vacancy rate in Denver for properties with section 8 LMSA was 1.7 percent compared to a market vacancy rate of 11 percent. In Houston, the vacancy rate for owners with section 8 LMSA was 5.7 percent compared to a market vacancy rate of 16.2 percent. Therefore, we concluded that owners of federally insured, low-and moderate-income housing projects in high-vacancy markets may face significantly less financial risk than owners of market rate properties. In such markets, owners would be unlikely to try to prepay and convert to market-based rental arrangements, and if they did, tenants should be able to find alternative low-income housing. In such cases, the windfall profits test of the 1990 act could allow HUD to deny incentives.

HUD's Use of Incentives to Deter Mortgage Prepayments

In this chapter, we answer our third evaluation question, which was to describe the various incentives HUD has provided to owners to prevent losses in the low- and moderate-income housing inventory. Specifically, we discuss HUD's use of incentives authorized under the Emergency Low Income Housing Preservation Act of 1987 to prevent mortgage prepayments, the cost of these incentives, and the timeliness of HUD's negotiations with private property owners.

What Incentives Were Available and How Did HUD Implement Them?

In passing the 1987 act, Congress applied an interim solution to the prepayment problem by requiring that HUD be notified of an owner's intent to prepay a mortgage and that, in all prepayment cases, the owner develop a plan of action, acceptable to HUD, demonstrating no adverse effects of prepaying on low- and moderate-income households. In practice, the act imposed a moratorium on prepayments. It required that HUD, after taking local market conditions into account, use the following incentives to deter prepayments:

1. Increase the allowable distribution or other measures to increase the rate of return on investment.

2. Revise the method of calculating equity.

3. Increase access to residual receipts accounts or excess replacement reserves.

4. Provide insurance for a second mortgage under section 241(f) of the National Housing Act.

5. Increase rents on an existing contract under section 8 of the United States Housing Act of 1937, or provide additional assistance under section 8 or an extension of any project-based assistance attached to the housing.

6. Finance capital improvements under section 201 of the Housing and Community Development Act amendments of 1978.

7. Facilitate a transfer or sale of the project, authorized in other provisions of law, to a qualified nonprofit organization, limited equity tenant cooperative, public agency, or other entity acceptable to the Secretary of HUD.

8. Provide other incentives authorized in the law.

As of March 29, 1990, HUD had received 103 notices of intent to prepay mortgages, affecting 16,872 households located in 24 states, the District of Columbia, and Puerto Rico. The owners of 47 of these 103 properties submitted the required plans of action to apply for prepayment and termination of low-income use restrictions. A significant portion of these properties were located in tight housing markets in California and Massachusetts—42 percent of the notices of intent to prepay and 51 percent of the plans of action. Table 4.1 shows the locations and the number of plans submitted.[1]

Table 4.1: Notices of Intent and Plans of Action Filed as of March 29, 1990

Location	Notices of intent	Plans of action	Number of units
California	32	19	3,563
Colorado	2	0	65
District of Columbia	1	1	99
Hawaii	1	0	149
Idaho	1	0	32
Illinois	7	3	1,547
Indiana	9	1	2,025
Kentucky	2	2	72
Louisiana	2	1	274
Maryland	3	1	456
Massachusetts	11	5	3,007
Michigan	4	3	891
Nebraska	1	0	60
Nevada	1	1	126
New Jersey	1	0	95
New York	2	2	804
Ohio	1	0	108
Puerto Rico	2	0	693
Rhode Island	1	1	102
South Carolina	1	0	40
Tennessee	1	0	76
Texas	6	2	973
Vermont	2	2	336
Virginia	4	2	847
Washington	3	1	125
Wisconsin	2	0	307
Total	**103**	**47**	**16,872**

[1]According to HUD, as of December 31, 1990, the Department had received 171 notices of intent and 38 plans of action had been approved—37 for extensions of use restrictions and one for prepayment that resulted in an owner converting the property out of the low-income housing inventory.

According to HUD, the agency had approved 10 (or 21 percent) of the plans of action; one was allowed to prepay and nine were granted financial incentives in lieu of prepayment.[2] Of the nine properties granted incentives, two were sold to a nonprofit owner with plans for future ownership transfer to a tenant cooperative, and one was sold to another for-profit owner.

Costs of Incentives Used by HUD

HUD approved a broad range and combination of incentives to influence owners to extend low-income use restrictions on their properties for nine instances in five states: five in California, two in Vermont, and one each in Michigan and Virginia. Table 4.2 presents a summary of the types of incentives HUD approved, the number of housing units preserved, and the average first-year costs of incentives per housing unit.

Table 4.2: Summary of Approved Incentives

Project	New section 8	Increased existing section 8	Increased returns	Equity takeout loan	Flexible subsidy loan	Capital improvement loan
1	Yes	Yes	Yes	Yes	No	No
2	Yes	No	Yes	Yes	No	Yes
3	Yes	Yes	No	No	Yes	Yes
4	Yes	Yes	No	No	Yes	No
5	Yes	Yes	Yes	No	No	No
6	Yes	No	Yes	Yes	No	Yes
7	Yes	No	Yes	No	No	No
8	Yes	No	Yes	No	No	No
9	Yes	No	Yes	No	No	No
Total properties	**9**	**4**	**7**	**3**	**2**	**3**
Number of units	463	447	911	295	336	372
Cost per unit	$5,262	$3,569	[a]	$25,172	$8,929	[b]

[a]The costs per unit of increased returns cannot be projected.

[b]While three capital improvement loans were approved, the amount of the loans was yet to be determined at the time of our study.

Nine properties were granted new section 8 contracts, which improved cash flows and returns on 463 additional housing units. The first-year cost of preserving these units for low- or moderate-income tenants was

[2]The owner prepaid the mortgage, and the property, which was virtually uninhabitable, was restored. The housing units remained available to low- and moderate-income tenants.

about $2.4 million in total, or $439 per household per month in additional rent subsidies. Four of the nine property owners also received increased rents for 447 units with existing section 8 LMSAs at a cost of about $1.6 million for the first year, or $297 per household per month in additional rent subsidies. One problem with providing new section 8 funds for these projects is that it redirects the funds to preserve low- and moderate-income housing, which leaves less money available to assist families residing in other financially troubled projects in the HUD-insured inventory.

Seven of the for-profit owners were allowed to revalue their equity in the properties, increasing their annual rate of return. According to HUD's Office of Preservation, revalued equity is based on the net present value of the subsidized rental income stream, less current indebtedness. HUD changed the rate of return from the previously authorized 6 percent on original investment to 6 percent on revalued equity for three properties, 10 percent on revalued equity for one property, and unlimited returns for the other three properties, provided that they were in good physical condition and adequate reserves were available for repairs.

HUD also approved three types of loans to preserve six of these properties. Three for-profit owners were granted section 241(f) equity loans totaling $7.4 million. Three for-profit property owners were granted supplemental capital improvement loans, and one owner of two nonprofit properties got flexible subsidy loans totaling $3 million at 1-percent deferred interest.

Unfortunately, three conditions prevent us from extrapolating from these cases to the cost of preserving the entire at-risk inventory. First, HUD has approved too few incentive packages to date. As HUD and property owners gain experience in negotiating incentives, there will probably be shifts in the average costs for preserving affordable housing. Second, the properties for which incentives have been approved are generally located in strong markets where rental costs are highest; thus, the incentives would tend to be more costly than incentives required to preserve properties in softer markets. Third, changes in the law in 1990 may change the cost of incentive packages.

Costs of Nonprofit Transfers Versus Costs of Providing Incentives

Some housing experts have suggested that many low- and moderate-income units could be retained through transfers of ownership to tenant groups or other nonprofit organizations. As of March 29, 1990, two contiguous projects had been sold to one nonprofit owner. In these cases, involving 163 additional subsidized units, the direct federal costs were about $675,000 in first-year section 8 LMSA funds ($4,141 per unit annually, or $345 per month in rent subsidies) and $3 million in federal loans. (This excludes the federal capital gains tax revenues on sale that would have offset part of the direct federal budget costs.) By comparison, for the seven for-profit properties receiving incentives, involving 300 subsidized units, the direct costs for the first year totaled about $1.8 million in section 8 LMSAs ($5,871 per unit annually, or $489 per month in rent subsidies) and another $7.8 million in federal loans. Section 8 contracts also were extended 3 years for one of the seven properties, preserving 90 units with first-year costs totaling $210,391 ($2,338 per unit or $195 per month in rent subsidies).

However, there were substantial additional costs for these transfers. The Vermont Housing Finance Agency, the city of Burlington, Vt., and a nonprofit organization all were heavily involved in facilitating the transfers. Financial assistance from the state, city, and local organization was needed to complete the transfers. In addition to direct federal government funding, the two transfers required $17.5 million in state and local loans and notes and a loan of $695,000 to the developer, a nonprofit organization, from another nonprofit organization. Moreover, according to the nonprofit owners, project acquisition might not have been possible had the city not passed a law restricting conversions from low-income housing without replacement.

The total and per-unit costs of these transfers are compared to the costs of incentives for the other projects in table 4.3. Overall, the federal costs were less per unit for the transfers to nonprofit ownership than for incentives to retain for-profit owners. However, nonfederal loans resulted in much higher per-unit borrowing for the transfers. Principal and interest payments on these loans could make the total annual costs for the transfers higher than that for the other properties, even though the federal costs (both section 8 and other federal loans) are lower. Of course, the transfers occurred in a market, Burlington, which may not be comparable to those where incentive packages were approved, most of which were in California. Moreover, Burlington's local ordinance limiting conversion of low-income housing could have affected the costs for these transfers.

Table 4.3: Comparative Costs of Incentives and Transfers

Source of funds	Incentives	Transfers
New section 8 subsidies (first year only)	$1,761,223	$675,000
Increased existing section 8 subsidies (first year only)	988,846	605,664
Loans (principal only)		
Federal	7,425,600	3,000,000
State/local/private	0	18,200,000
Total loans	7,425,600	21,200,000
Costs per unit		
New section 8 subsidies (first year only)	5,871[a]	4,141[b]
Increased existing section 8 subsidies (first year only)	3,609[c]	3,501[d]
Loans		
Federal	19,908[e]	8,929[f]
State/local/private	0	54,167
Total loans	19,908	63,096

[a]Based on an additional 300 units.

[b]Based on an additional 163 units.

[c]Based on increased subsidies for 274 units.

[d]Based on increased subsidies for 173 units.

[e]Based on projects with 373 units.

[f]Based on projects with 336 units.

According to the state housing finance agency, the principal achievements represented by this transaction were the

- immediate preservation and rehabilitation of the units as affordable housing;
- long-term preservation of the units as affordable housing, with a reserve structure designed to take care of future repairs and capital improvements without the need for prohibitive rent increases or new debt;
- integration of low-income housing tax credits with HUD incentives and other sources of state and local financing; and [3]
- nonprofit development and tenant participation in ownership and management.

The parties to this transaction, including the state, the nonprofit organization, and a housing consultant involved in negotiating the transfer, agree that while HUD inspections did not reveal substantial repair needs,

[3]The new nonprofit owners formed a for-profit general partnership to take advantage of available tax credits to improve project cash flows.

about $6.5 million were needed for repairs just to bring the project up to standards. Therefore, they caution that care must be taken to ensure that projects are in adequate physical condition before HUD allows owners to withdraw built-up equity.

Timeliness of the Incentive Approval Process

According to HUD records, 6 of the 10 approved prepayment incentive cases exceeded the 180 days for approval or disapproval provided in the Emergency Low Income Housing Preservation Act of 1987. This figure understates the timeliness problem, because HUD records show that HUD inappropriately stopped the "180-day clock," pending owners' submission of a revised plan of action in cases where HUD had issued a notification of deficiencies in the original plan of action. However, on May 18, 1989, HUD directed its field offices to discontinue this practice of stopping the clocks. Therefore, the time owners use to adjust their plans of action now is counted.

Interviews With Parties Involved in Negotiating Incentives

To determine if HUD was handling negotiations in a timely manner, we conducted interviews with HUD field office staff involved in negotiating the first project approvals. Further, we interviewed five of the owners of the nine projects that HUD had approved for incentives as of March 29, 1990.[4] We also talked to state and nonprofit organization officials on their perceptions of how well HUD had implemented the 1987 act.

According to HUD field officials, the main reasons for delays in the process were HUD's inexperience in implementing the act and insufficient formal guidance. In some cases, this lack of experience and insufficient guidance may have led the agency to approve greater incentives than were necessary to preserve projects. For example, a key HUD San Francisco regional official involved in negotiating two of the earlier plans of action told us that HUD headquarters did not provide clear guidance and that time was needed to establish procedures to implement the 1987 act. Further, according to this official, the first deals negotiated were probably more costly than they would have been if HUD had had more experience. (We did not independently assess whether these deals could have been closed at lower cost, however.)

[4] We did not attempt to contact the former owner of the only project that had been approved for prepayment, since this project has been preserved for low- or moderate-income housing under a state program.

Four of the five owners we interviewed told us that they were satisfied with the level of incentives approved and that the level of financial support was adequate to prevent prepayment, absent the moratorium on prepayments then in place. However, at the time of our interviews, none of these owners had actually received the equity loans HUD promised. Further, all of these same owners told us that the process to approve the incentives was burdensome and untimely and that HUD assumed an adversary role in negotiations, which delayed the process. Owners' complaints included (1) a lack of written policy guidelines on mortgage prepayments and processing plans of action, (2) HUD's lack of experience, and (3) the perception that HUD officials purposely delayed and blocked negotiations. In regard to the last point, we note that HUD's mandate to represent the interests of the federal government and tenants in such negotiations might lead owners to perceive the agency in an adversarial light.

Have Defaults Resulted From Delays?

During hearings, the Subcommittee asked us to examine whether delays by HUD in processing applications for prepayment or incentives could result in owners defaulting on their mortgages. We did not find any cases where default resulted from a delay in processing a prepayment or incentive application. This is not surprising, because we would not expect owners with substantial equity to default. As of February 1990, 199 HUD properties were recommended for foreclosure, and 85 projects were in foreclosure, for a total of 284 properties in default, or 17 percent of a total inventory of 1,692 properties. These 284 properties include about 17,000 units. Table 4.4 summarizes the multifamily HUD-held inventory foreclosures by region.

Table 4.4: Foreclosures in the Multifamily HUD-Held Inventory as of February 1, 1990

Region	Foreclosures	Inventory	Percent
Boston	12	127	9
New York	21	172	12
Philadelphia	19	154	12
Atlanta	33	225	15
Chicago	29	403	7
Fort Worth	121	284	43
Kansas City	25	97	26
Denver	3	48	6
San Francisco	16	142	11
Seattle	5	40	12
Total	**284**	**1,692**	**17**

Conclusions, Recommendations, Agency Comments, and Our Response

In this chapter, we present our conclusions and make recommendations to the Secretary of HUD concerning the implementation of the prepayment-related provisions of the Low-Income Housing Preservation and Resident Homeownership Act of 1990. We also include a summary of HUD's comments on an earlier draft of this report and our response to those comments.

Conclusions

Overall, we conclude that consistent estimates of the maximum number of low- and moderate-income insured rental units eligible for mortgage prepayments or preservation incentives are available, based on reasonable agreement about the size of the total inventory and about the number of units that are eligible for prepayment. That is, up to 367,000 units appear to be eligible for mortgage prepayments.

Estimates of the probable number of units for which prepayment may be sought are uncertain, however. Both HUD and the Preservation Commission seriously tried to make these estimates; however, we believe that there are problems with both studies. The HUD method of relying on loan service officers' opinions of whether specific properties were likely to prepay at any time projected over a 20-year period seemed particularly weak, especially given that consistent criteria were not specified. The Preservation Commission's model is a useful analytical tool, but as with most such models, its predictions are subject to error from uncertainty about important parameters (for example, the projected rate of rental inflation), variables omitted from the model, and unforeseeable events. Moreover, the data the Preservation Commission used were based on only 198 properties eligible for prepayment, a sample size probably adequate for generating overall national estimates but far too small to account for differences among housing markets. Nevertheless, combined with HUD's effort to improve the quality of the data in its files, the model offers promise as a tool for projecting the likely volume and costs of prepayments or incentives to deter them.

We also conclude that the likelihood of owners seeking to prepay mortgages in order to convert their properties to uses other than low- or moderate-income housing depends on conditions in the housing markets where individual properties are located. In high-demand low-supply markets, the appreciation in property values has resulted in a large built-up equity, which makes prepayment and sale or conversion very attractive to owners. By contrast, in low-demand high-supply markets, the risks of competing in the open market are far less attractive, and the relatively low vacancy rates and virtually guaranteed rental income

associated with continued participation in the federally subsidized programs make prepayment attempts unlikely.

Finally, we conclude that HUD needs to improve the training and guidance it provides to field staff as it implements legislation to deal with the prepayment issues. In part because of insufficient guidance and training, HUD has not consistently met the time requirements for processing and acting on plans of action contained in the Emergency Low Income Housing Preservation Act of 1987. This can be an especially serious problem under the 1990 act because owners will be permitted to prepay and void use restrictions if incentives cannot be made available within 15 months of approval by HUD.

We recognize that HUD has taken several steps to address these problems. For example, since we completed our work HUD has prepared updated field instructions and has established the Affordable Housing Branch of the Office of Multifamily Housing Preservation and Property Disposition, with the sole purpose of responding to policy and guidance inquiries from field offices about processing plans of action. In addition, HUD has provided continuing training to field staff on mortgage prepayments and related issues. Nevertheless, we found that, even after training, field office staff still reported they were uncertain about how to negotiate incentive packages, and many loan service officers lacked knowledge they would need to do so.

Recommendations

We recommend that the Secretary of HUD ensure that its regional and field office market economists participate in delimiting the relevant local markets (as defined in section 215(a)(2) of the Low-Income Housing Preservation and Resident Homeownership Act of 1990) for the federal cost limits test and in determining whether there is an inadequate supply of decent, affordable housing for the windfall profits test. In addition, we recommend that the Secretary (1) enhance HUD's staff expertise in real estate finance through hiring, training, and contracting in order to ensure better and more timely negotiation of incentives, and (2) review current guidance being provided on negotiating incentive packages in light of the 1990 legislation, providing better guidance where necessary.

Agency Comments and Our Response

HUD provided comments on a draft of this report (see appendix III) in which the agency raised two major issues and a number of other, mostly technical concerns. First, HUD disagreed with our original draft recommendation that it develop a formula for targeting areas where incentives would be offered to owners to deter prepayments. However, this concern was addressed by Congress in the 1990 act, as discussed in chapter 1. Therefore, the draft recommendation that HUD develop a formula is moot and has been deleted from this report.

Second, HUD disagreed with our findings that its field offices often failed to meet statutory deadlines for processing plans of action and that it needed to improve the skills of its staff and provide more guidance to field offices concerning the negotiation of incentives. HUD conceded that the 1987 "statute does require that notifications of . . . approval or lack of approval be given to the owner within . . . 180 days," but argued that "there is no requirement for a Plan of Action to be approved" within that time period. Subsequent discussions revealed that HUD had misinterpreted our finding as indicating HUD was required to approve a plan of action within 180 days; we have changed the draft slightly to clarify our meaning that HUD had to act (approve or disapprove a plan of action) within 180 days.

HUD acknowledged that "enhanced skill training would most likely improve the timeliness of the process," and recited its recent efforts along these lines. However, HUD disagreed with our findings about lack of guidance, citing the publication of field instructions in 1988 and updated 1990 guidance, which, though unpublished at the time of their review of our report, had been provided in draft form to HUD field offices. They also pointed out that HUD had established the Affordable Housing Branch within the Office of Multifamily Housing Preservation and Property Disposition "solely to respond to policy and guidance inquiries from field offices about processing Plans of Action." We have noted all these efforts in the report, but retain the recommendation because, despite these training efforts, we found that HUD staff often evinced a need for additional training and guidance in how to negotiate incentive packages.

HUD also raised a number of issues in response to our criticisms of the methods it used to estimate potential losses, as reflected in its 1987 testimony. While HUD agreed with our assessment that the questionnaire it used to collect information from its field offices did not seek information that "would have been valuable" in estimating likely losses, it argued that this information "was not available in-house and could not be

obtained quickly." We continue to believe that HUD's estimates were weakened by the lack of information on certain key variables that could affect owners' prepayment decisions, but note in our text that HUD may not have had sufficient time to collect such information.

HUD also took issue with our criticism of the procedure whereby HUD central office staff modified the estimates of likely losses made by field staff to produce the national figures presented in HUD's testimony. HUD claimed this procedure was justified as a way of improving the uniformity of results, especially given the "wide range of loan servicers' knowledge and expertise, and their lack of a broad national perspective." We believe that HUD has failed to provide sufficient justification for the changing of field staff estimates of likely owner decisions by central office staff. In the first place, this procedure was not even mentioned in the testimony, where the estimates were presented as the result of a survey of loan service officers only. This omission reduces the ability of users of the data to assess their validity and reliability. Second, HUD does not demonstrate that central office staff had better information on individual owners' likely decisions than did the loan servicers. In the absence of such a demonstration, it is difficult to support a conclusion that the estimates were improved by changing those made by field officials with first-hand knowledge of the individual properties, however imperfect that knowledge.

The remaining issues HUD raised have been addressed by changing the text of the report, where appropriate.

Request Letter

HENRY B. GONZALEZ, TEXAS,
CHAIRMAN

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STAFF DIRECTOR

(202) 225-7054

December 20, 1989

Honorable Charles A. Bowsher
Comptroller General
General Accounting Office
441 G Street, N. W.
Washington, D. C. 20548

Dear Comptroller General Bowsher:

The House Subcommittee on Housing and Community Development is concerned about the potential loss of thousands of units of privately owned low- and moderate-income housing. These multi-family rental housing units have mortgages that are insured under the Section 221(d)(3) and Section 236 programs through the Department of Housing and Urban Development. While Congress has taken action to prevent immediate losses through the Housing and Community Development Act of 1987 and successor legislation, these provisions expire on September 30, 1990. However, to address this problem in the future we require information on the magnitude of the losses that can be expected. While a number of studies have attempted to estimate such losses, the estimates show considerable variation.

We understand the staff of GAO's Program Evaluation and Methodology Division and Denver Regional Office are completing work on a study relevant to the Subcommittee's concerns. We request that GAO report the results of this work to the Subcommittee to assist us as we work to resolve this problem. Specifically, we would like GAO to address the following questions:

1. What is the range of estimates of likely losses in the Section 221(d)(3) and 236 programs as reported in the various studies done in recent years?

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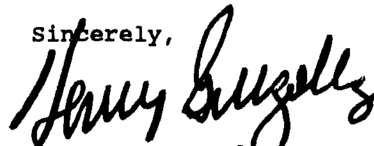
2. How sound are these studies in terms of the technical and methodological quality of the data and models used? Are the models capable of dealing with variations among housing markets?

3. Based on your analysis, are the ranges of estimated losses reported methodologically reasonable?

4. How has HUD used available incentives to keep the insured properties in low- and moderate-income rental housing stock? Are these incentives adequate both to deter losses of such housing and to insure that the housing will be maintained by owners?

Please have your staff contact Frank T. DeStefano of the Subcommittee staff as soon as it is possible on 225-7054 to discuss details of this assignment and arrange for a formal briefing and follow-up report on your findings.

Sincerely,



Henry B. Gonzalez
Chairman

HBG:FD/jb

Description of HUD's Subsidy Programs for Low- and Moderate-Income Tenants

Program	Status	Description
Section 221(d)(3): Market Rate	Inactive	Enacted in 1954 to insure mortgages on properties designed for low- and moderate-income and displaced families.
Section 221(d)(3): Below Market Interest Rate	No new commitments since 1968	Amended section 221(d)(3) in 1961. Provides up-front subsidies that reduced to 3 percent the interest rate on private 40-year mortgages for multifamily rental housing built by nonprofit or limited-dividend organizations. Reduces rents for income-eligible tenants.
Section 221(d)(4)	Active	Created in 1959 to insure mortgages on housing for the elderly.
Section 236	No new commitments since 1973	Authorized in 1968 to replace below market rate program. Provides monthly subsidies that reduce to 1 percent the interest rate on private 40-year mortgages for new multifamily rental projects. Reduces rents for income-eligible tenants.
Section 8: Loan Management Set-Aside and Property Distribution	Active	Authorized in 1974. Provides subsidies to units in financially troubled projects in the FHA-insured inventory and on sale of HUD-owned projects, respectively. Subsidy contracts from 5 to 15 years with owners help ensure improved cash flows and preserve projects for lower income tenants. Subsidies cover the difference between tenant payments and the unit rents.
Section 8: New Construction and Substantial Rehabilitation	No new commitments since 1983, except for elderly and handicapped families	Enacted in 1974. Provides rental subsidies to income-eligible households in new or substantially rehabilitated projects. Subsidy covers the difference between tenant payments and fair market rent, determined by HUD and based initially on capital and operating costs. Subsidy contracts for 20 to 40 years commit owners to set aside a certain number of units for lower income households for a period of time.
Section 8: Moderate Rehabilitation	Active	Authorized in 1979. Aids in bringing households in existing units up to standard with modest repairs. Differs from Section 8: Existing Housing program (see below) only in that aid is tied to the rehabilitated unit, whose rent is limited to 125 percent of the local fair market rate for existing units.
Section 515: Rural Rental Assistance	Active	Enacted in 1962. Farmers Home Administration provides 50-year direct loans to developers at 1-percent interest. Reduces rents for income-eligible tenants.

(continued)

Program	Status	Description
Section 8: Existing Housing Certificates	Active	Authorized in 1974. Aids income-eligible households, who can choose any existing unit that meets the program's property standards and whose rent does not exceed the fair market rate. HUD pays the difference between actual rents and tenant payments, with funding committed for 5 to 15 years. Administered by local public housing agencies who enter into contracts with landlords.
Section 8: Vouchers	Active	Authorized in 1983. Similar to section 8 certificate program in that assisted households can live in standard units of their choosing and public housing agencies administer the program. Unlike certificates in that recipients may occupy units with rents above the voucher payment standard—roughly equivalent to the fair market rate—if they pay the difference. They may keep the difference if rents are below the payment standard. Funding is committed for 5 years.

Source: Derived from Congressional Budget Office, "Current Housing Problems and Possible Federal Responses," Dec. 1988.

Comments From the Department of Housing and Urban Development

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

NOV - 6

Ms. Eleanor Chelimsky
Assistant Comptroller General
General Accounting Office
Washington, D.C. 20548

Subject: Draft Report: Rental Housing: Mortgage Prepayments, Local Markets Place up to 367,000 Families at Risk (GAO/PEMD-91-2)

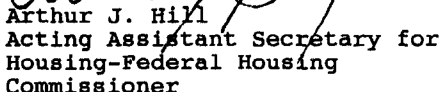
Dear Ms. Chelimsky:

Secretary Kemp has asked this office to respond to your letter of October 9, 1990, subject as above. Our full comments are enclosed with this letter.

The Department believes that it has implemented Title II of the Housing and Community Development Act of 1987, as amended, in accordance with the intents of the Congress. We, therefore, disagree with a number of the conclusions and recommendations set forth in the draft report. We are also concerned that these conclusions and recommendations were not discussed with the Department during the exit conference on August 2, 1990.

We suggest that the appropriate GAO officials meet with our program officials to clarify the requirements of Title II prior to publication of the final report. This meeting may be arranged through Ms. Audrey Hinton, Acting Director, Office of Multifamily Housing Preservation and Property Disposition at 708-3343.

Sincerely,



Arthur J. Hill
Acting Assistant Secretary for
Housing-Federal Housing
Commissioner

Enclosure

Department of Housing and Urban Development comments on General Accounting Office Draft Report: Rental Housing: Mortgage Prepayments, Local Markets Place up to 367,000 Families at Risk (GAO/PEMD-91-2)

A. Findings and Recommendations

1. Chapter 3:

The recommendations which conclude this chapter do not conform to the basic requirements of the statute. It is not possible to respond to them without also responding to the recommendations in the Executive Summary.

a. **HUD should consider GAO's finding that in markets where housing demand is low relative to supply, prepayments and subsequent conversions are unlikely, even without further incentives.**

In implementing the 1987 HCDA, the Department recognized that there must be a market test of the efficacy of a potential prepayment and conversion of use. To that effect the implementing regulations at 24 CFR 248.233(b) require that the owner of the housing produce a qualified appraisal which clearly demonstrates that the housing has a higher and better use than low income housing before the property can be considered for incentives. In those areas where there is no demonstrable higher and better use, that is, where the market affords the owner no prepayment and conversion opportunity, incentives are not offered by the Department.

b. **At the same time, in high demand, low supply markets current incentives might not be sufficient to prevent prepayment.**

This statement confuses the discrete functions of Sections 225(a) and 225(b) of the statute. In order for the Department to approve a Plan of Action which allows prepayment and termination of the affordability restrictions, the Department must make the findings set forth in Section 225(a). If the Department cannot make the findings in Section 225(a), it may offer the owner incentives, as set forth in Section 224, under a Plan of Action to extend the affordability restrictions under Section 225(b). If the owner does not feel that the incentives offered are

sufficient, <u>he may not automatically prepay</u>. The owner may <u>only</u> prepay and terminate the affordability restrictions if the Department can make the findings of Section 225(a). Our experience with owners who feel that the incentives are insufficient to meet their expectations is that they have withdrawn their Plans of Action and are waiting for replacement legislation to the 1987 HCDA.

c. **Therefore, HUD should develop a formula to identify local markets where prepayments are likely so that incentives can be targeted to those areas, rather than to markets where prepayments are not likely.**

In light of the above, this recommendation is moot. Both Plans of Action to prepay and terminate the affordability restrictions and Plans of Action with incentives to extend the affordability restrictions are captive to local market conditions; the former by meeting the findings for prepayment in Section 225(a) of the statute and the latter by meeting the "higher and better use" test in 24 CFR 248.233(b).

Therefore, GAO's recommendation that "incentives be targeted to avoid prepayment" misses the intent of the statute and the requirements incumbent on the owner and HUD for either allowing termination of the affordability restrictions or extending the affordability restrictions with incentives. Further, GAO's recommendation that "HUD should develop a formula for identifying areas where prepayments are likely" to determine such targeting is unnecessary.

2. <u>Chapter 4</u>:

a. **We conclude that HUD has not complied with the time requirements for processing and approving plans of action contained in the Emergency Low Income Housing Preservation Act of 1987. HUD should improve the timeliness of processing plans of action and negotiating incentives by enhancing staff expertise in real estate finance through hiring, training and contracting, and by providing better guidance to field offices on how to negotiate incentive packages.**

This recommendation asserts that the Department has been lax in "timely" approving Plans of Actions, and attributes that lack of timeliness to a concomitant lack of training and guidance.

First, there is no requirement in the statute that Plans of Action be processed or approved by any date certain. While the statute does require that notifications of deficiencies and approval or lack of approval be given to the owner within 60 and 180 days respectively, there is no requirement for a Plan of Action to be approved within those time periods. Also, this finding does not account for an owner's option to simply not respond to the Department or to request that process exceed 180 days (Section 227(b)(1)), nor does it recognize that the statute clearly provides the owner with an unlimited number of opportunities to revise his Plan of Action (Section 227(b)(2)).

Secondly, the Department acknowledges that enhanced skill training would most likely improve the timeliness of the process. In fact intensive field staff training sessions were held in both Regions where GAO conducted its study (Boston and San Francisco) and conducted the bulk of its interviews. Additionally, training in this process was offered nationally on four separate occasions over the past two years as a portion of comprehensive multifamily management training. We still recognize the continuing need to provide enhanced skill training to field office staff not just for prepayments, but for all of the Department's multifamily management programs.

We disagree with the comments about the lack of guidance. Comprehensive field instructions were issued on May 20, 1988 and July 14, 1988, copies of which were provided to GAO. An updated compendium of field instructions has been ready for publication since June of this year. Its formal publication was prevented by the lack of OMB approval of the final regulations at 24 CFR 248 until September 21 of this year. Now that the regulation has taken effect on October 22, these instructions are planned for publication. However, copies of the draft instructions have been provided to all field

offices. Further, the Department has established in the Office of Multifamily Housing Programs, the Office of Multifamily Housing Preservation and Property Disposition. The Affordable Housing Branch in this office serves solely to respond to policy and guidance inquiries from field offices about processing Plans of Action. We are unaware of any outstanding matters of policy or guidance requests from any field office which has not been formally addressed.

B. General Comments

1. **GAO's criticism of HUD's 1987 estimates of likely prepayments (pp. 2-13, 2-15) is mistaken and misunderstands of the purpose and origin of these estimates, or the time constraints on their development. These estimates were not derived from formal study, but rather, from a poll of Field Offices and pragmatic use of in-house knowledge. Their purpose was to provide Congress, the Department, and interested members of the public, with quick initial information on likely scope and significance of prepayments.**

   a. GAO refers to the 1987 Congressional testimony by the A/S for Housing as the "HUD 1986 study" and asserts (p.2-13) that this study to produce these estimates "contains serious methodological flaws". HUD did not, however, conduct a study in 1986; there was no formal research design or data collection outside HUD; and, therefore, this pragmatic in-house estimation cannot properly be scrutinized using the standards of formal research.

   Rather, in 1986, HUD drew upon staff expertise in Central and Field Offices to make quick-turnaround estimates of the seriousness of prepayments. Fielding a study would have required more time than Congress had available for its initial deliberations on prepayment. HUD's quick estimates were a reasonable in-house assessment, and probably the *best that could be done in the absence of a study* and a program of outside data collection. The HUD staff that performed this work deserves credit for putting prepayment in perspective; for providing a base for the National Low Income Housing Preservation Commission, GAO, and others who did subsequently conduct studies; and for demonstrating what appears to be the key

finding of GAO's own inquiry: **Prepayment, rather than threatening the full stock of assisted properties, is at any time limited to subsets of properties where local markets would provide superior returns to owners than would continued operation under HUD's mortgage programs.**

b. GAO criticizes the questionnaire HUD used (p.2-15) because "it lacked items seeking information on ... market value and alternative uses, cost data for needed repairs...and whether...conversion costs are not prohibitive." The missing information they cite would, of course, be valuable, but was not reliably available in-house and could not be obtained quickly. HUD appropriately directed its questionnaire to loan officers because queries of outside respondents was infeasible--it would have required time-consuming OMB clearance, competitive contract processing, hiring specialists, and designing research. The questionnaire properly excluded items which would have required direct measurement by specialized professionals--market appraisers, architects/engineers,etc., who were not available--and instead, made best use of the varied information available to loan servicers.

GAO's criticism of these omissions is, in fact, negated by their subsequent observation that loan servicers have limited property-specific information. HUD's questionnaire to loan servicers would have produced little useful information about repair costs, market value, or conversion costs.

c. In criticizing knowledge of loan servicers about properties, GAO uses questionable methodology. For a sample of properties, GAO compared (p.2-16) two sets of estimates of physical condition, property values, and conversion costs, one set made by loan servicers, the other by owners. Not surprisingly, GAO found differences between these estimates, and with no justification, attributed these differences to faulty information from HUD loan servicers. GAO should instead have drawn upon independent experts to provide accurate estimates for these objective items, and then compared their findings with owners' guesses and loan servicers' judgments. Owners, many of whom live in cities or even states far from their properties, many of whom visit their properties infrequently, have often told HUD that they do not have accurate assessments of condition, value, or conversion costs.

As GAO found, however, loan servicers were extremely accurate in estimating owners' intention to prepay or not (pp.3-12,3.13): servicers estimated that 3 of 19 tight market owners are likely to prepay (versus 2 of 19, based on the owner survey), and none of 11 in soft markets (identical to owners' responses). This seems to validate HUD's poll of loan servicers as one input in developing its estimates.

d. GAO criticizes (p.2-17) the fact that HUD's central office staff may have modified the raw estimates provided by loan officers to produce national figures for A/S Demery's testimony. Once again, GAO is confusing research analysis and pragmatic, judgmental policy analysis. HUD was not conducting a study, but instead, was drawing upon all sources of in-house knowledge to produce our best quick estimates. Thus, HUD used the poll of loan servicers as one input, but also relied on the judgments of senior loan management experts in central office to produce our best estimates of prepayment within a short time frame. This improved the uniformity of results and was entirely in keeping with deriving judgmental estimates, particularly given the wide range of loan servicers' knowledge and expertise, and their lack of a broad national perspective.

e. GAO concludes (p.2-26) that the "Preservation Commission's model was a far more useful analytical tool" than HUD's. Since HUD did not produce, or even attempt to produce, an analytical tool, this conclusion is questionable.

2. **GAO's criticism of the study by the National Low Income Housing Preservation Commission (pp. 2-18 through 2-26) is out of date and omits the intensive work by the Congressional Budget Office to test and correct the Commission's model and findings. This is a major omission. GAO also errs on several points:**

a. GAO states (p.2-23, 1st paragraph) that owners "seldom operate .. with information as complete as those in the model." On the contrary, once an owner focuses seriously on the decision of whether to prepay, then the owner will spend sums needed to obtain better and more complete data than the model contained. The owner will obtain much better data than the model used on the true costs/revenues of operating the property under HUD's programs; on the property's market potential; and on conversion costs.

b. GAO states that the Commission's sample "is too small to permit information on specific markets to be analyzed, a major limitation given the sensitivity of real estate decisions to local market conditions" (p.2-23, 2nd paragraph), and that this is "a sample size far too small to account for differences among housing markets" (p.2-26). This criticism does not hold--the Commission had 198 observations with corresponding market data for each. This continuum of market data is more than adequate for multivariate statistical analyses of impacts of local markets on owners' decisions.

The Commission's sample was not, however, designed to report the probable number of prepayments or defaults by geographic regions of the nation, which would have been far too costly for their budget.

c. In the same paragraph, GAO's third point is that the model assumes "no government action ... to prevent displacement." While this may be true, more seriously, the model contains faulty assumptions regarding properties' future repair expenditures and incomes, assumptions that drive properties quickly into prepayment or default. The model assumes that each property will have, in perpetuity, annual repair needs derived from HUD's measure of their one-time extraordinary repair needs backlog; that these needs not only will continue after this backlog has been met, but will actually escalate annually; that owners will have no discretion and will make all repairs regardless of the property's income until they are deeply, and hopelessly in debt; and that HUD will allow no rent increases in response to owners' increasing repair expenditures, leading to a situation of nearly fixed revenues in the face of overwhelming capital repair and replacement programs. In fact, HUD's routine loan management operations would result in approved rent increases to cover some or all of the repair expenditures. At present, exactly what is the best estimate of future repair needs is debatable, pending findings from HUD's ongoing Multifamily Stock Study.

d. GAO notes (p-2-24, second paragraph) that the model "appears to be sensitive to assumptions about a number of parameters ... a serious limitation on the model's predictive utility." This statement is incorrect, perhaps reflecting a misunderstanding of such models. The model is not a black box that automatically produces the appropriate result: it requires the user to supply the appropriate range for key parameters. The model, properly run on a range of assumptions, can be used to produce a probability-weighted range of results.

3. GAO used a case study approach to examine prepayment issues in the two extreme market situations: "high demand and low supply" (Los Angeles and Boston), and "low demand and high supply" (Denver and Houston). These specific markets were "recommendations of housing experts". GAO focused on mortgages eligible for prepayment in the near term, through September 30, 1994 to answer their "basic question ... whether owners' expected decisions to prepay ... are strongly related to local housing market conditions which are principally influenced by factors such as vacancy rates and appreciated property values."

a. Methodology Issues:

o How did these four markets compare at the time to other markets across the nation in terms of vacancy rates and property value appreciation, GAO's primary criteria indicators? Were they in fact at the extremes? If so, how much of the national prepayment inventory was also in markets at these polar extremes? What was the date when these markets were selected? Even in a case study, this contextual information is necessary to understand the implications of findings.

o GAO selected a "judgment sample" of properties eligible for prepayment (p.3-2) from HUD's MIDLIS files. MIDLIS does not provide the necessary and reliable information (accurate ownership type, whether prior owners were nonprofit, whether Flexible subsidy or rent supplement essentially preclude prepayment) to distinguish whether or not a property is eligible for prepayment. Did GAO somehow supplement MIDLIS? What were the specific criteria for their judgment? These are important considerations for interpreting the case study for national policy.

- o GAO interviewed owners of just 30 of the 51 properties in their judgment sample--a little over 60%. How was this 60% selected, and how did it differ from the other 40%? GAO states (p.3-3) that the "interviews were intended to be illustrative; we did not have the time necessary to do a survey that could provide nationally representative estimates." The time pressures that GAO faced were comparable, but no more severe, than those faced by HUD and the Commission in developing their estimates. Does GAO feel their sample was representative of the four sample areas, or of all of the "tight" and "soft" markets across the nation?

- o As noted elsewhere in these comments, GAO "compared responses of [loan servicers and owners] ... to determine how closely HUD's predictions matched the owners' intentions and whether owners' and HUD's opinions were similar regarding the current market value and physical condition of the properties." (p.3-3). This approach makes sense for owners's intentions. However, for the other items, which are objective, measurable, conditions, GAO should have been obtained measures from expert market appraisers and physical inspectors.

- o What was the nature of GAO's interview methodology, survey guides and questionnaires? Can copies be appended to the report? Were questions asked uniformly, particularly across market areas and between owners and HUD? Did their interview technique avoid bias and leading subjects?

b. <u>Regarding Table 3.1, p.3-5</u>,

- o What were owners' assumptions about future use or use restrictions, and future subsidy streams for their properties in estimating "average appreciation/depreciation rate"? Is this column meant to be appreciation under highest and best non-subsidized use, appreciation under current low-income HUD mortgage use, or appreciation after prepayment and termination of subsidies, but with continued use restrictions (as could be required for certain properties having Section 8 or Flexible Subsidy)?

- o The table presents vacancy rates and appreciation, for the four markets. What was the distribution of these market factors within each of the four areas, since owners make decisions based on their submarkets rather than just on their broad market conditions?

- c. It seems surprising (p. 3-12, 1st paragraph) that owners' reasons for investing in low- and moderate-income housing did not include the guaranteed long-term rental income and vacancy protection provided by Section 8 contracts. Did GAO's survey somehow bias responses, particularly for owners of 221(d)(3) market rate properties having full Section 8 coverage?

4. In discussing owner incentives (p.4-8, 1st paragraph), GAO should make clear the required linkage between section 241 equity loans and rent increases, including Section 8 units, to indicate that this is not cost free to the Treasury: equity take out loans are only possible when HUD increases rents and subsidies sufficiently to amortize the loans.

5. We believe that GAO cannot generalize (p.4-9, last paragraph), based on the small number of transfers studied, on the relative cost of transfers to nonprofit ownership versus incentives to retain for-profit owners. Regarding these transfers to nonprofits, GAO asserts (p.4-13, 1st paragraph) that "the federal government will not be faced with providing more incentives for these properties 20 years from now and tenants' rents need not increase except to cover operating expenses." GAO does not offer evidence to support this conclusion. Nonprofit owners may fail, their for-profit partners may balk, and HUD may be called in to rectify the situation with financial inducements or subsidies.

6. GAO notes (bottom p.4-15, p.4-16) that as of February, 1990, 284 HUD properties were either recommended for foreclosure or in foreclosure. How does this, and Table 4-17, relate to the properties eligible to prepay (334 to 425 properties, with the most likely number being less than 367)? These 284 include mostly properties not part of the 367, and have little empirical relevance to the study question.

7. There are several technical problems with the section on "Matters for Congressional Consideration" (p.4-18)

a. GAO states that they recommend two approaches to minimize preservation costs, but then list three items.

b. GAO recommends giving "right of first refusal" in purchasing projects to states, local governments, nonprofits, and tenants when owners seek prepayments, but only one of these entities can have first right of refusal. Furthermore, this recommendation does not appear to be based upon the analyses presented in the report.

8. GAO criticizes HUD for failing to render proper program guidance to field offices, on the basis of commentary from an unidentified Regional official, asserting that "the first deals were probably more costly" if such guidance had been rendered (pp. 4-14 and 4-15). Again, this region (San Francisco) was one of two where in-depth training was held. Moreover, it is irresponsible for GAO to publish a comment about the probable costs of any Plans of Action without at least reviewing those plans and making a finding regarding the costs relative to other Plans of Action in the same market area. The Department has complied with the statutory requirement that "the package of incentives is, for the Federal government, the least costly alternative that is consistent with the achievement of the full purposes of this title" (Section 225(b)(2)). Indeed, GAO's own analyses of the costs of nine incentives packages does not make any finding regarding costliness or excessive cost.

9. GAO also criticizes HUD, on the basis of comments received from one owner, that "HUD assumed an adversarial role in negotiations" and that "HUD purposely delayed and blocked negotiations" (p. 4-15). While we feel it is proper for the Department to represent the Federal government and the tenants in the negotiations, it is to be expected that disagreements over value and compensation may create the appearance of an adversarial transaction. Such an occurrence, however, cannot imply that the Department assumed an adversarial role independent of some facet in the negotiating process. Further, GAO has presented no evidence that the Department has engaged in any practices to "delay" or "block" the process. We recommend that GAO delete these recommendations from the final report.

10. Additional Comments

a. Page 2-3 states that as Section 8 contracts expire HUD has proposed replacing the rental assistance with vouchers. This was true in the late 1980's but HUD's current policy is to replace expiring contracts in-kind, i.e., certificates replaced with certificates, LMSA replaced with LMSA, etc.

b. GAO claims (p.2-11) to have discovered errors in MIDLIS, citing that "some properties listed as eligible for prepayment were, in fact, owned by nonprofit organizations which are ineligible to prepay, or owned by for-profit organizations ineligible for other reasons."

This is not accurate. MIDLIS has no variable that purports to show eligibility for prepayment, and GAO has mis-specified the problem. MIDLIS does have an ownership type variable that HUD told them is not fully maintained; this variable may indicate either the current owner type, the original owner type, or some other prior owner's type. However, even where the entry is accurate and up to date, MIDLIS will not indicate whether, for example, a currently indicated limited dividend owner purchased the property from a nonprofit (which would make the mortgage ineligible for prepayment).

c. p.1-4, 1st paragraph, last sentence refers to the wrong appendix.

p.G-3, does 221(d)(3) belong in this discussion, which seems to be describing the section 236 rental structure?

p.G-5, residual receipt accounts apply only to limited dividend owners.

p.G-5, last sentence, Section 8 certificate holders are free to move only within the local jurisdiction.

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Glossary

Definitions are drawn from "Preventing the Disappearance of Low Income Housing," a report of the National Low Income Housing Preservation Commission, Washington, D.C., 1988.

Basic Rent

The minimum rent charged for a unit in sections 221(d)(3) and 236 properties, calculated by determining the operating expenses, allowed returns, and debt service at 1- or 3-percent interest. Tenants pay the basic rent or 30 percent of their income (but never more than market rent), whichever is greater. For very low-income tenants not receiving additional rent subsidies, such as rent supplement payments or section 8 assistance, this can mean a rent burden much higher than 30 percent of income. For higher income tenants, the rent payment is proportionate to their income but not necessarily as much as the unit would command if rents were totally uncontrolled.

Below Market Interest Rate

Enacted in 1961 (section 221(d)(3)) and continued through 1968, this program provided an up-front subsidy effectively reducing interest rates on privately written FHA mortgages to 3 percent. In return, rents paid to the limited-dividend or nonprofit owners were controlled by FHA. New tenants generally could not have an income exceeding 95 percent of the median. Tenants paid the established FHA rent or, if their income exceeded 110 percent of the median for the area, an amount equal to 120 percent of the FHA rent. Returns on equity for limited dividend owners were limited to 6 percent, with any excess going into a special "residual receipts account."

Contract Rent

The rent an owner actually charges for a unit occupied by a tenant receiving section 8 assistance. The contract rent can be less than the applicable fair market rent determined by HUD, but may not exceed it for a unit of a given size and type.

Fair Market Rent

Rent annually calculated by HUD and used to establish maximum rents that may be charged for section 8 properties. The rents represent the 45th percentile of rents paid by renters who have moved into a standard existing nonsubsidized dwelling unit during the past 2 years, adjusted for size, type, and the particular housing market. The fair market rent for existing housing is adjusted upward to reflect accurately the higher rents for rehabilitated and newly constructed units.

FHA Rent

The rent calculated to accommodate the total of debt service at a below-market interest rate, operating costs, and (for limited-dividend owners), a reasonable rate of return.

Loan Management Set-Aside

Since 1976, this form of rent supplement has been available through the section 8 program to section 236 properties. For some properties, LMSAS replaced 40-year rent supplements or rental assistance payments. This exchange was advantageous to owners because it shortened the length-of-use restrictions and because section 8 provides a budgetary cushion to cover inflation in operating costs, allowing owners to improve their cash flow to financially troubled properties. Like the other rental assistance programs, section 8 aid limits the tenant's rent payments to 30 percent of adjusted income. The term of section 8 contracts is 15 years. Prior to 1983, owners were permitted to cancel their contracts every 5 years. Since 1983, this "opt-out" provision is no longer offered to owners. With LMSA, rents on projects older than 6 years are renegotiated. The newly established rent generally may not exceed the section 8 existing fair market rent for the area.

Low Income

Generally used to refer to families with incomes no greater than 80 percent of the area's median, adjusted for family size.

Market Rent

In the section 236 program, the maximum rent that can be charged based on a calculation of operating expenses, allowable returns, and debt service at market rate. This rent is identical to basic rent, except that it includes an allowance to cover the mortgage insurance premium and the component meant to amortize the unit's mortgage is calculated at a level sufficient to pay off the loan at the full unsubsidized interest rate at which it was written. Any amounts collected by landlords over the basic rents revert to HUD. This "market rent" is not the same as the usual use of the term to describe the going rent for similar apartments in a market area. The section 236 "market rent" may be higher or lower than the true market rent, and may also be different from the so-called fair market rent or "allowable rent" that HUD permits under the Section 8: Existing Housing Program.

Moderate Income

Generally refers to families with income between 80 and 95 percent of the area's median.

Phantom Income

Income generated by a partnership in excess of the amount of cash distributions actually received. Examples include rental income used to pay mortgage principal, or net income in excess of allowable dividends that is required to be placed in a reserve account.

Rent Supplement and Rental Assistance Payments

Enacted in 1965, these programs provided subsidies to reduce rent burdens of low-income tenants in section 221(d)(3) and 236 properties to 30 percent of tenant income. The subsidies made up the difference between the basic rent and what low-income tenants could afford to pay for rent at 30 percent of their income. Up to 100 percent of tenants in section 221(d)(3) properties and 40 percent (with the HUD Secretary's approval) of the tenants in section 236 properties could be assisted through rent supplements. Without such subsidies, many tenants, particularly those with incomes below 50 percent of the median, could not afford to rent the properties. Payments were available for a maximum of 40 years (or for the remaining life of the mortgage), but starting in 1976, many were replaced by Loan Management Set-Asides.

Residual Receipt Account

An account established by the mortgagee on behalf of a limited dividend owner of a section 221(d)(3) or 236 property. This account, which may bear interest, receives any money available at the end of the fiscal year that is in excess of the allowable 6-percent dividend. Money cannot be withdrawn from the account without HUD approval, but it is available to the owner when the mortgage is repaid.

Section 8: Existing Housing Program

A tenant-based subsidy program that makes up the difference between what tenants can afford to pay for rent at 30 percent of adjusted income and the rent being charged for a modest, standard apartment. The subsidy is paid to the owners on behalf of the tenant. Tenants are free to occupy any unit that meets acceptable standards of repair and that rents at or below an established maximum rent level (existing fair market rent). Tenants are free to move within the local jurisdiction and take their assistance with them.

Section 236 Program

Active between 1968 and 1973 (although some final endorsement dates—start of mortgage loan—were as late as 1980), this program provided subsidies to reduce mortgage interest rates to 1 percent. In exchange for the favorable interest rates, owners were required to keep rent low and to rent to tenants with incomes at 80 percent or less of the

median income. Tenants paid a "basic rent" or 30 percent of income (up to an established market rent), whichever was higher. Very low-income tenants paying more than 30 percent of their income for the basic rent were assisted through rent supplements. Limited-dividend owners were limited to a 6-percent return on equity. Any excess income derived from relatively higher income tenants paying more than the basic rent was returned to an "excess income account."

Very Low Income

Generally refers to families with incomes no greater than 50 percent of the area's median, adjusted for family size.

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