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MULTIFAMILY HOUSING

Issues Related to Mark-to-Market Program Reauthorization

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Director, Physical Infrastructure Issues

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the preliminary results of our analysis of various issues relating to the reauthorization of the “mark-to-market” program established by the Multifamily Assisted Housing Reform and Affordability Act of 1997. We expect to report our final results in early July 2001. Our work is being carried out in accordance with the provisions of section 521 of the act, which required us to review the Office of Multifamily Housing Assistance Restructuring’s (OMHAR’s) administration of the mark-to-market program.

As you know, the mark-to-market program is aimed at preserving the affordability of low-income rental housing while reducing costs to the federal government of rental assistance subsidies provided to low-income households. More specifically, the program provides the framework to restructure insured Section 8 properties in the Department of Housing and Urban Development’s (HUD’s) multifamily housing portfolio by lowering their rents to market levels when their current Section 8 contracts expire and reducing their mortgage debt if such action is necessary for the properties to continue to have a positive cash flow. Without restructuring, rents for many of the approximately 8,500 properties in HUD’s portfolio substantially exceed market levels, resulting in higher federal subsidies under the Section 8 program.

As provided for in the act, OMHAR has contracted with public and nonpublic entities (referred to as participating administrative entities or PAEs) to carry out the mark-to-market restructurings on behalf of the federal government. The participating administrative entities are responsible for developing restructuring plans for the properties assigned to them and submitting the plans to OMHAR for review and approval. The entities perform two types of restructurings. The first type of restructuring, referred to as a full mortgage restructuring, involves resetting a property’s rents to market levels and reducing its mortgage debt by the amount needed to permit the property to achieve a positive cash flow. The second type of restructuring, referred to as a rent restructuring, involves reducing the property’s rent to market levels, but not reducing its mortgage debt. This type of restructuring generally occurs when the property is physically and financially sound enough to continue operation at market-level rents with its existing mortgage.

Legislative authorization for the mark-to-market program and OMHAR is scheduled to terminate on September 30, 2001. If authorization is not extended, after that date HUD will still be required to renew Section 8 contract rents at market levels, but the tools established by the act for restructuring mortgages will no longer be available. OMHAR's authority would also terminate and any outstanding mark-to-market responsibilities will be transferred to HUD's Secretary.

Our statement today will focus on three of the issues that we are addressing in our current engagement: (1) the status of the mark-to-market program; (2) factors that have affected the pace of program implementation and the actions OMHAR has taken to address these factors; and (3) the advantages and disadvantages of extending the program past its statutory termination date and of transferring program responsibilities to HUD or keeping them with OMHAR. It also presents matters for the Congress' consideration in debating the reauthorization of the mark-to-market program and OMHAR.

In carrying out the assignment, we analyzed data on the mark-to-market program's status and interviewed representatives from a variety of program stakeholders, including 10 public and 5 nonpublic participating administrative entities. We also convened an expert panel composed of 10 program stakeholders representing OMHAR, HUD, participating administrative entities, lending institutions, tenant associations, Section 8 property owners, and non-profit organizations to discuss the issues that we agreed to address. (See app. I).

In summary:

- As of May 2001, approximately 1,500 properties had entered OMHAR's mark-to-market program. About 60 percent of these properties are expected to receive full mortgage restructurings and the other 40 percent are expected to receive rent restructurings only. OMHAR has completed the restructuring process for 12 percent of the properties requiring a full mortgage restructuring and 84 percent of the properties requiring only rent reductions. OMHAR estimates that the federal government will realize about $499 million in savings over a 20-year period from the restructurings that it has completed thus far. However, for some properties that do not successfully complete the restructuring process, the requirement to reduce rents to market has decreased the properties’ cash flows, thus increasing the likelihood that the properties will develop physical and financial problems.

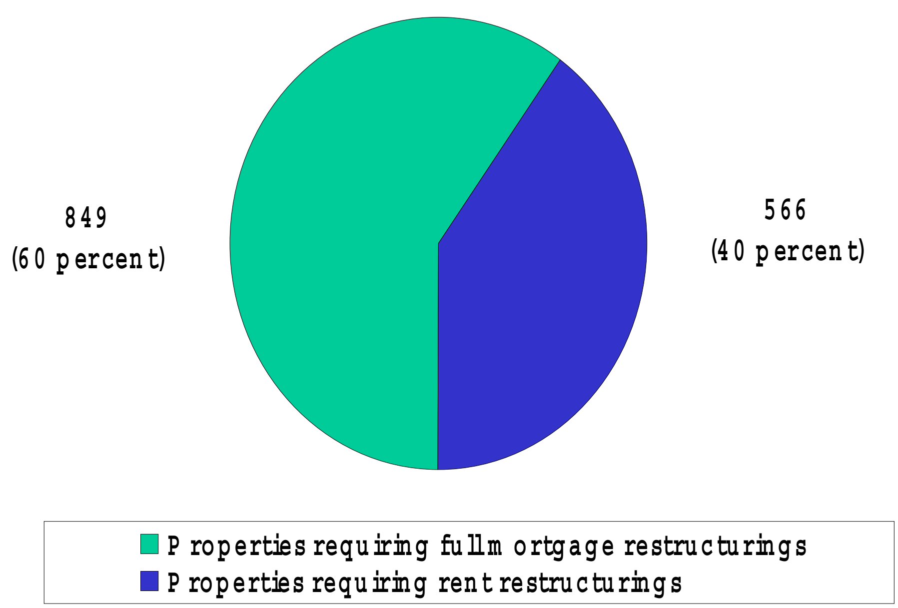
- Various factors have affected the pace at which the program has been implemented. It took almost 2 years to establish the program’s infrastructure and for OMHAR to begin assigning a large volume of properties to the entities that would carry out restructuring actions. Other factors may have slowed the restructuring process as well, including OMHAR’s process for reviewing and approving restructuring transactions, the detailed requirements contained in the program’s operating procedures guide, and the unwillingness of many Section 8 property owners to participate in the program. However, OMHAR has taken actions to address these factors, and many program stakeholders believe that the pace of the program has improved. Furthermore, while the program has proceeded more slowly than OMHAR originally estimated, many program stakeholders we contacted believe that OMHAR’s progress in implementing the program has been reasonable given the program’s complexity and the number of tasks that needed to be accomplished.

- Extending the mark-to-market program past its scheduled termination date would be more advantageous to the federal government than ending the program. If rents must be marked down to market levels without provisions for mortgage restructuring, many Section 8 properties with above-market rents are more likely to default on their mortgages, resulting in large claims against the Federal Housing Administration (FHA) insurance fund. All of the program stakeholders who participated on our panel support the continuation of the program beyond September 30, 2001. Furthermore, we agree with the view expressed by most program stakeholders that administration of the mark-to-market program should continue to reside in an office dedicated to the program’s implementation and that the office should have the resources and expertise needed to administer the program and to oversee restructuring transactions.

OMHAR Estimates that Completed Restructurings Will Generate $499 Million in Savings But Risks to Some Properties Have Increased

As of May 15, 2001, OMHAR had assigned over 1,400 of the 1,500 properties entering the mark-to-market program to the participating administrative entities for restructuring. As shown in figure 1, about 60 percent of these properties are to receive full mortgage restructurings, and the remaining 40 percent are to receive rent restructurings only.

Figure 1: Number and Percentage of Properties Requiring Full Mortgage Restructurings Compared to Properties Requiring Rent Restructurings

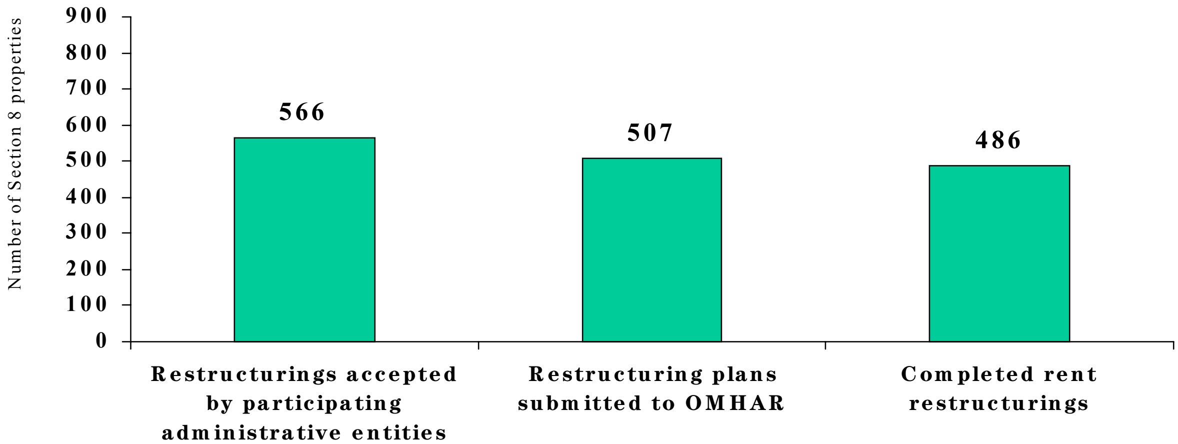


Source: GAO analysis of OMHAR's database

To date, OMHAR has completed substantially more rent restructurings than full mortgage restructurings. As of May 2001, OMHAR had completed 486 rent restructurings or 84 percent of all properties in this category.[1] (See fig. 2.)

[1] OMHAR considers the participating administrative entity's "plan approval date" as the completion of the rent restructuring process while the "closing" date marks the completion for full debt restructurings.

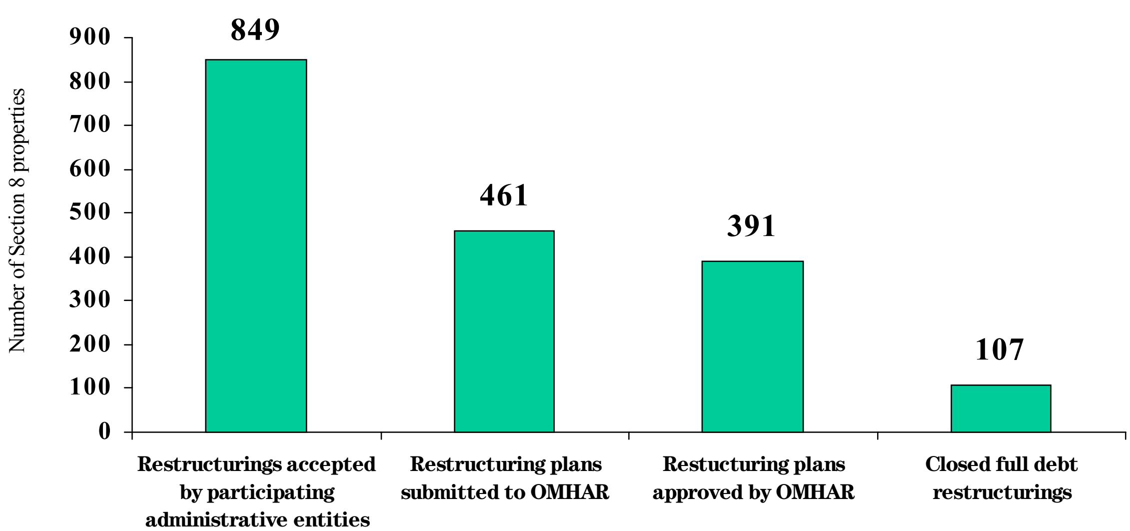
Figure 2: Status of Rent Restructurings in the Mark-to-Market Pipeline as of May 15, 2001



Source: GAO analysis of OMHAR's database

As shown in figure 3, as of May 2001, OMHAR had completed 107 full mortgage restructurings or 12 percent of all assigned and working properties of this type.

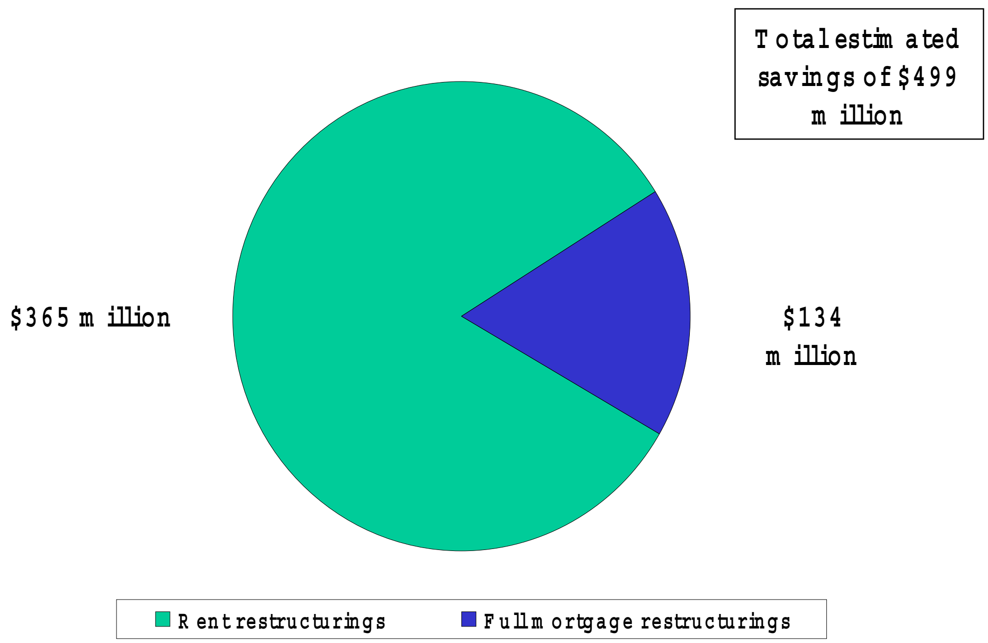
Figure 3: Status of Full Mortgage Restructurings in the Mark-to-Market Pipeline as of May 15, 2001



Source: GAO analysis of OMHAR's database

OMHAR estimates that restructurings completed as of May 15, 2001, will generate approximately $499 million in savings (net present value) over the next 20 years. Of this total, rent restructurings account for $365 million in savings and full mortgage restructurings account for the remaining $134 million.[2] (See fig. 4). These savings result primarily from reductions in the government's Section 8 rental assistance payments after property rents have been lowered to market levels. The savings estimate takes into account costs that the government has incurred as a result of mortgage write-downs, but it does not include OMHAR's or participating administrative entities' administrative costs, which have totaled $53.9 million as of May 2001.

Figure 4: Estimated Mark-to-Market Program Savings by Type of Completed Restructuring Over 20 years (Net Present Value)



Source: GAO analysis of OMHAR's database

While the mark-to-market program has resulted in Section 8 savings, the requirement that rents be reduced to market levels has increased the risk of physical and financial problems for some properties. For example, the completed rent restructurings include transactions for 76 properties that did not meet OMHAR's underwriting criteria to be

[2]The savings calculations for rent restructurings exclude 74 properties (out of the 486 completed rent restructurings) that did not result in Section 8 savings. The savings calculations for mortgage restructurings include savings resulting from the 107 restructurings that OMHAR has closed and 56 restructurings for which OMHAR reduced property rents but did not complete a mortgage restructuring.

processed as rent restructurings. In other words, these properties received a rent restructuring even though OMHAR's analysis showed that the properties' income may not be sufficient to cover mortgage payments, operating expenses, and ongoing repair needs after the properties' rents were reduced to market. OMHAR said many of these properties should have been processed as full mortgage restructurings, but the Office lacked the legal authority to compel property owners to accept such restructurings. Because of the potential for problems to occur at these properties that could affect the properties' physical and financial condition, in August 2000, HUD's Office of Housing issued guidance establishing additional requirements for its field offices to follow in monitoring these properties. In addition, for 56 properties that OMHAR has processed as full mortgage restructurings, OMHAR reduced the properties' rents to market without completing the restructuring of the properties' mortgages. OMHAR believes that many of these restructurings are unlikely to be completed. While these properties also have an increased risk of problems related to their physical and financial condition that could affect their future viability and also affect the properties' residents, we found that they were not specifically covered by HUD's monitoring guidance. However, HUD has recently agreed to revise the guidance so that it will include these properties.

Factors Cited as Slowing Mark-to-Market Implementation and OMHAR's Actions to Address Them

Establishing OMHAR and implementing the mark-to-market program has been a lengthy process. For example, after the passage of the act creating OMHAR and the program in October 1997, it took a year for the Director of OMHAR to be appointed. Soliciting, selecting and negotiating contracts with the participating administrative entity was not completed until January 1999 and OMHAR did not begin to assign a large volume of properties to the participating administrative entities for restructuring until July 1999. Other implementation tasks completed during that time included preparing the program's operating procedures guide, issuing regulations, and developing an Internet-based tracking system to monitor mark-to-market activities. While these tasks were completed behind OMHAR's original schedule, OMHAR said the delays were due to the normal challenges associated with starting a new organization. Appendix II presents a timeline showing when key mark-to-market implementation tasks were completed.

Some program stakeholders believe that other factors have also slowed the implementation of the program. These include:

- Requirements contained in the program's operating procedures guide, which some stakeholders believed were too extensive;

- OMHAR's review of restructuring plans, which some participating administrative entities regarded as excessive and often not resulting in improvements to the restructuring plans;

- Some Section 8 property owners' unwillingness to cooperate in the restructuring process; and

- Some participating administrative entities not submitting timely and high quality restructuring plans to OMHAR for approval.

In an effort to increase the program's production, OMHAR has taken action to address the factors cited as slowing the program's implementation. These actions include:

- Streamlining the policies and procedures found in the operating procedures guide to simplify the process;

- Conducting a seminar with the OMHAR staff who review the restructuring plans submitted by the participating administrative entities to emphasize OMHAR's commitment to production, discuss review requirements, and solicit input on simplifying the process;

- Introducing an incentives package to make participation in the program more attractive for owners; and

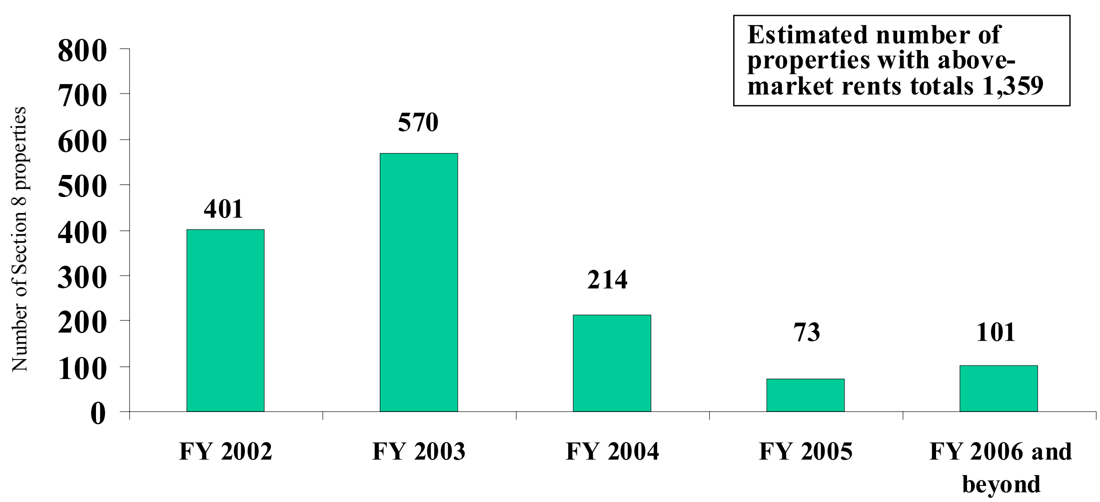
- Organizing special teams to assist participating administrative entities in the completion of restructuring transactions.

OMHAR and others believed the program has gained momentum and that the pace for completing restructurings has improved. Many stakeholders, including over half of the participating administrative entities we contacted, believed that the time required to complete the restructurings has decreased. Furthermore, while implementation of the program has taken considerable time, program stakeholders noted that the program was more complex than originally anticipated, involved a considerable number of stakeholders, and provided few incentives to encourage owner participation. Many stakeholders we contacted believed OMHAR' s overall progress in implementing the mark-to-market program has been reasonable.

Expiration of Program Authority and Potential Implications

The statutory authority to restructure properties' mortgages under the program expires on September 30, 2001. After that time, when their current Section 8 contracts expire, Section 8 properties with above-market rents that have not entered into a binding commitment with OMHAR will have their rents reduced to comparable market levels without the mortgage restructuring tools available in the program. As shown in figure 5, HUD estimates that over 1,300 Section 8 properties with above-market rents will expire after the scheduled termination of the program.

Figure 5: Estimated Number of Section 8 Properties with Above-Market Rents Expiring Beyond Fiscal Year 2001



Source: HUD's Office of Housing

If mark-to-market program authority is not extended, owners will be placing themselves and HUD at risk of financial losses if their property's reduced rents are insufficient to pay for debt service, reserves, and operating costs. Owners of properties who are unable to operate efficiently at market rents may be forced to decrease expenditures for maintenance and other operating costs in order to remain current with mortgage payments, thereby placing tenants at risk of residing in substandard housing. In addition, the FHA insurance fund is likely to be adversely affected if property owners that are unable to meet their financial obligations eventually fail because proper restructuring tools were not available.

Our work has found that consensus exists among the program stakeholders we contacted that the mark-to-market program should be extended. For example, all expert panelists agreed that allowing the program to expire would increase the likelihood of Section 8 property defaults and large claims against the FHA insurance fund. Panelists had different recommendations on the length of program extension ranging from 3 years to an indefinite extension. For example, one said that if there is a legal requirement to reduce the rents to market, there should always be a corresponding authority to restructure the debt. Several panelists also emphasized that a decision on extending program authority is needed as soon as possible.

Loss of Dedicated Office to Administer the Program Could Affect Program Momentum and Reduce Expertise

OMHAR's legislative authority to administer the program also expires on September 30, 2001. After that, OMHAR's authority and responsibilities are transferred to HUD's Secretary. A preliminary transition plan, provided to the Congress in December 2000, sets out three options for the transfer of OMHAR's responsibilities to HUD:

- HUD could maintain an organization resembling the current structure at OMHAR;
- HUD could create an organization resembling a reduced OMHAR in HUD's Office of Multifamily Housing; and
- HUD could merge restructuring responsibilities into HUD's 18 Multifamily Hubs.

Our work has found that significant concern exists among many program stakeholders regarding the transfer of program responsibilities to HUD's Office of Multifamily Housing. For example, 9 out of 10 expert panel members and 8 of out 15 participating administrative entities indicated that OMHAR should be allowed to continue administering the program. These parties cited a number of problems that could arise if the program were transferred to HUD's Office of Multifamily Housing and, particularly, if the responsibility were assigned to HUD's Multifamily Hubs.[3]

Transferring responsibilities to another location in HUD without dedicated staff to administer the program could disrupt momentum. In addition, loss of expertise could occur if OMHAR staff are not retained. According to OMHAR, 57 percent of the 89 staff currently employed with OMHAR have limited terms and do not have reemployment rights with HUD. OMHAR said most of the staff with limited terms (about 75 percent) are those with production experience. According to OMHAR's Director, if OMHAR is not extended it would be necessary for HUD to obtain approval from the Office of Personnel Management to extend their terms. Furthermore, the act allows OMHAR staff to receive higher pay than comparable HUD employees. Accordingly, OMHAR believes that unless the provisions allowing higher pay are extended, a substantial number of the remaining staff may choose to leave. There was also concern that even if OMHAR staff transferred to HUD's Office of Housing, unless they were assigned to a specific office focused on the mark-to-market program, they could be dispersed to work on other HUD multifamily programs.

There was also concern that HUD's Office of Multifamily Housing may lack the capacity to effectively administer the program if OMHAR staff are not retained and responsibility for the program is shifted to HUD Multifamily field offices. A survey that we conducted of HUD field office managers in September and October 2000 supports this view. The survey found that 71 percent of the HUD field office managers believed that their offices do not have sufficient staff to carry out existing programs and activities. This lack of capacity could, in our view, affect HUD's ability to ensure that the program is being

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[3]HUD's 18 Multifamily Hubs and their associated 33 program centers comprise HUD's field offices. The field offices report to HUD's Office of Multifamily Housing.

carried out in accordance with legislative requirements and that the federal government's interests are adequately protected.

However, some program stakeholders favored the transition of program responsibilities to HUD's Office of Multifamily Housing. For example, one expert panelist and 7 out of 15 participating administrative entities believed that OMHAR's authority of the program should be allowed to expire. Reasons cited by the one panelist and the participating administrative entities for transferring program responsibilities included the following: (1) integration of the program into HUD's Office of Multifamily Housing could improve program efficiency with the streamlining of the mark-to-market decision-making process and execution of policies since one office would be administering all aspects of Section 8 properties entering the program; (2) integration of the program into HUD's Office of Multifamily Housing could improve communication and coordination between the participating administrative entities and HUD; and (3) OMHAR's oversight has been too prescriptive and heavy-handed and HUD field offices would be better suited to provide program oversight since the HUD field staff are more knowledgeable about the local rental markets and are more familiar with the Section 8 properties located in their jurisdictions.

Conclusions

If the legislative authority to restructure mortgages under the mark-to-market program is allowed to expire on September 30, 2001, HUD estimates it will have to reduce the rents to market levels of well over 1,000 properties without having the tools needed to mitigate the potential effects of such reductions. If the reduced rents do not provide sufficient revenues for the properties to cover their operating expenses, mortgage payments, and repair needs, owners may be forced to reduce expenditures for maintenance or other operating expenses or may default on their mortgages. Such actions could result in deteriorating property conditions and substantial claims against the FHA insurance fund, which, in turn, could adversely affect property residents and lead to a decrease in the supply of affordable housing. Extension of the program would permit Section 8 property owners with above-market rents and unexpired Section 8 contracts to benefit from the restructuring tools that are currently available and help offset many of the effects that are likely to occur if the program is not continued.

Transferring authority for the mark-to-market program to HUD's Office of Housing could potentially help facilitate the handling of some mark-to-market related functions that have required coordination between OMHAR and the Office of Housing. However, there are concerns that such a transfer is also likely to result in the loss of a substantial number of OMHAR staff unless the terms of existing staff are extended and staff are allowed to continue receiving higher salaries than other HUD staff. A substantial reduction in the number of OMHAR employees assigned to the mark-to-market program could result in additional delays in program implementation and substantially diminish institutional knowledge of program requirements. Furthermore, concerns about the adequacy of staffing in HUD's field offices raise questions about whether HUD would be able to provide comparable program oversight of the mark-to-market program without straining its field office staffs' ability to carry out existing responsibilities.

While the mark-to-market program has brought about successful restructurings resulting in Section 8 savings at a number of properties, at other properties the requirement that rents be reduced to market has increased the risk of physical and financial problems. Those at risk include properties that have not received mortgage restructurings but for which market rents may not provide sufficient income to cover existing mortgage payments, operating expenses, and ongoing repair needs. HUD recognized that these properties may become troubled, and the Office of Housing developed guidance for its field offices to use in monitoring potentially troubled mark-to-market properties. However, the guidance did not explicitly cover all properties that may be at risk. HUD has acknowledged that the guidance should be more inclusive and has agreed to revise it. We plan to review HUD's monitoring of these properties as part of our future work at HUD.

Matters for Congressional Consideration

To permit continued restructuring of Section 8 properties with above-market rents, the Congress should extend Subtitle A of the Multifamily Assisted Housing Reform and Affordability Act beyond September 30, 2001. To ensure that restructurings are completed expeditiously and in accordance with legislative and regulatory requirements, and that the federal government's interests are protected, the Congress should also extend legislative requirements placing the mark-to-market program under a separate office headed by a director who is responsible for administering the program. Regardless of whether program responsibility continues within OMHAR or is transferred to a separate office elsewhere in HUD, the office should have a sufficient number of trained staff dedicated to program administration.

This concludes my statement. I would be pleased to answer any questions that you or other members of the Committee might have.

Appendix I: Panel Participants

Michael Bodaken, President, National Housing Trust

Scott Chamberlain, Assistant Vice President, GMAC Commercial Mortgage

Shaun Donovan, Deputy Assistant Secretary for Multifamily Housing Programs
U.S. Department of Housing and Urban Development, Office of Multifamily Housing Programs

Isha Francis, President, Benchmark Management Corporation

Michael Kane, Executive Director, National Alliance of HUD Tenants

Denise Muha, Executive Director, National Leased Housing Association

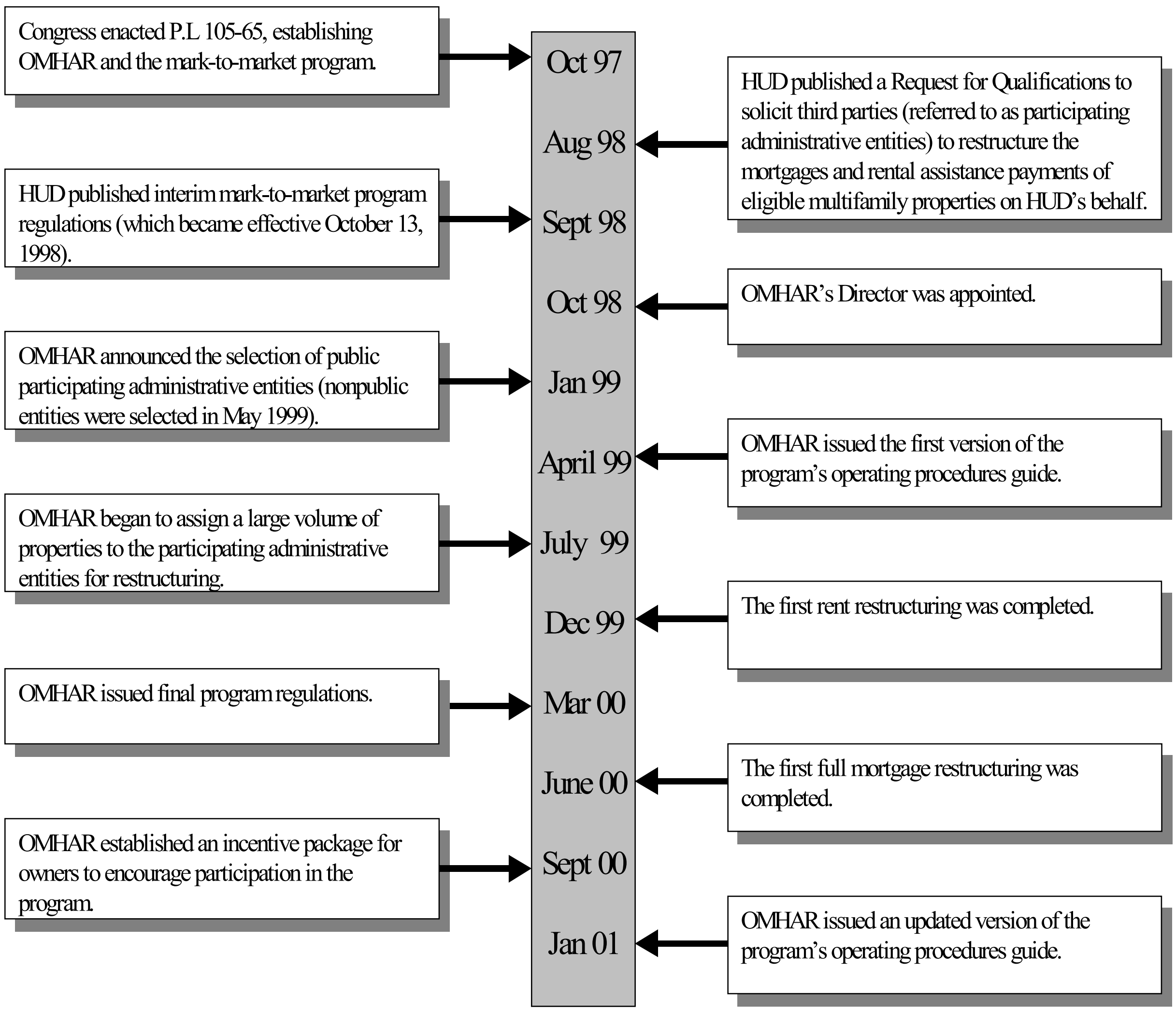
Ira Peppercorn, Director, Office of Multifamily Housing Assistance Restructuring

Garth Rieman, Director for Program Development, National Council of State Housing Agencies

Cathy Vann, President, Ontra, Incorporated

Chuck Wehrwein, Vice President of Acquisitions, Mercy Housing

Appendix II: Timeline of Mark-to-Market Implementation



Source: GAO analysis of HUD data

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