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Committee on Banking, Finance and Urban Affairs,
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MULTIFAMILY HOUSING

Impediments to Disposition of
Properties Owned by the
Department of Housing and
Urban Development

Statement of Judy A. England-Joseph, Director, Housing and
Community Development Issues,
Resources, Community, and Economic Development Division



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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to provide you with the preliminary results of our ongoing work, performed at your request, on the impediments to the sale of the Department of Housing and Urban Development's (HUD) multifamily property inventory. Over the past 3 years, the inventory of HUD-owned multifamily units has grown dramatically, from 10,000 units in 1990 to 27,000 units in 1992. In addition, HUD has initiated foreclosure on another 42,000 units, resulting in a total inventory of about 69,000 units that are either HUD-owned or under foreclosure. Concerned about this growing inventory, you asked us to determine why HUD is not selling these properties and what costs HUD is incurring while holding them. Our work is being performed at HUD headquarters and at the HUD field offices responsible for managing and selling the current multifamily property inventory. Although our work is ongoing and therefore subject to minor revision, we have discussed the information in this testimony with appropriate HUD officials who agreed with the facts presented.

In summary, we found that the most significant impediment to the disposition of HUD's multifamily housing inventory is the shortage of federal funds for rental subsidies needed to preserve units for low- to-moderate income tenants. However, once the federal government is obligated to preserve these units, HUD will pay the cost of preservation whether the properties are sold or whether they remain in HUD's inventory.

Current federal housing law, requires HUD, in selling its inventory, to pursue the goal of preserving a prescribed number of units for 15 years. A federal rental subsidy, known as Section 8 project-based assistance, is generally used to achieve this preservation, and HUD estimates that meeting the current housing law's preservation goals for its beginning fiscal year 1993 inventory would require as much as \$3 billion of this subsidy over 15 years. In addition, Mr. Chairman, when you add the properties that HUD estimates will enter the foreclosure process during fiscal year 1993, the Section 8 need could go as high as \$4 billion by fiscal year 1994. In fiscal year 1993, HUD did not request sufficient Section 8 appropriations to meet this need. In fact, HUD only requested \$110 million and was actually appropriated about \$93 million for this purpose.

Because the Section 8 subsidy HUD has available to sell the inventory is insufficient to meet the needs for preservation, HUD is unable to dispose of its properties; instead, it keeps them in inventory. As a result, HUD incurred holding expenses and debt service expenses estimated at \$248 million for fiscal year 1992. To preserve properties for low- to-moderate income tenants, the federal government pays the shortfall between property revenue and property expenses, regardless of whether the properties are sold and managed by new owners or kept in inventory and managed by HUD.

If the properties are sold, the shortfall would generally be paid for with Section 8 rental subsidy which is funded by appropriations from HUD's discretionary budget authority. If the properties remain in inventory, as is currently the case, the shortfall is funded through the Federal Housing Administration's (FHA) General Insurance Fund. Therefore, Mr. Chairman, two key policy issues result (1) how to fund the preservation of this low-income housing, and (2) whether HUD should own and manage the properties or whether they should be sold and managed by new owners. Current budget considerations result in a bias toward funding preservation through FHA's General Insurance Fund and having HUD own and manage the inventory.

We will soon provide you with our final report on the impediments to the disposition of HUD's multifamily inventory. Also, as you have requested, we are beginning work to determine how much HUD is recovering from the properties it does sell and what alternatives to Section 8 assistance are available to HUD to effectively dispose of its multifamily inventory. We plan to issue a final report to you on this matter by the end of 1993.

BACKGROUND

HUD has an inventory of multifamily properties that it has acquired mostly through foreclosing on defaulted loans originally insured by HUD's Federal Housing Administration (FHA). HUD's multifamily property disposition program was established to remove properties from this inventory by selling them to new owners. However, as required by the Housing and Community Development Act of 1987, when HUD sells these properties it must also pursue the goal of preserving some of the property units as affordable rental housing for low- to moderate-income people. To accomplish this, the Act requires HUD to provide financial assistance to purchasers in at least one of the following ways:

- by providing subsidies from a rental assistance program known as project-based Section 8. Under project-based Section 8, a qualifying tenant pays 30 percent of his/her income as a portion of the contract rent on a unit and HUD pays the property owner the remaining portion of the contract rent for the unit.
- by providing other financial assistance such as reducing the price of the property. This assistance must be provided on terms that ensure that the project will remain available and affordable to lower income persons and that they will not pay more than 30 percent of their income for rent.

In most cases, before HUD is allowed to sell a multifamily property out of its inventory, it must ensure that preservation is achieved. Generally, HUD has found that the most feasible

method to accomplish preservation is through the use of Section 8 funds.

SHORTAGE OF SECTION 8 FUNDS IS THE MAJOR IMPEDIMENT TO DISPOSITION OF PROPERTY

The shortage of project-based Section 8 subsidies is the most significant impediment to HUD's multifamily property disposition program. To dispose of the 441 properties with 69,300 individual units that were HUD-owned or under HUD's foreclosure process at the beginning of fiscal year 1993, HUD estimates that as many as 31,200 units would need to be preserved. HUD estimates that the per-unit/per-year cost of preservation is \$6,508. Therefore, preserving this number of units for low- to moderate-income rental housing for 15 years would result in a need for as much as \$3 billion in project-based Section 8 subsidy, in current dollars. This estimate could go as high as \$4 billion by the end of fiscal year 1993 if, as HUD estimates, 117 additional properties enter the foreclosure process during fiscal year 1993.

HOUSING LAW CREATES HUGE NEEDS FOR SECTION 8 FUNDS

Current housing law imposes a strong preservation goal on the disposition of HUD's multifamily inventory and provides for few exceptions to pursuing that goal. When the law's preservation goal is applied to HUD's currently large inventory, a huge need for Section 8 assistance is created.

Current Law Imposes a Strong Preservation Goal

Under the preservation goal of the Housing and Community Development Act of 1987, when HUD sells a multifamily property, some units will, in most cases, need to be preserved for rental by lower-income tenants. Preservation is required for a particular property if one of two conditions exist:

- At the time HUD paid off the mortgage lender, the property was receiving a HUD subsidy--such as a below-market interest rate loan or other rental payment assistance--or was receiving Housing Assistance Payments for more than 50 percent of its units. For these properties, known as "formerly subsidized" properties, 100 percent of the units in the properties must be preserved as affordable rental units for lower-income tenants.

- At the time HUD paid off the mortgage lender, the property was not receiving any HUD subsidy or was receiving Housing Assistance Payments for fewer than 50 percent of the units in the property and was therefore known as a "formerly unsubsidized" property but was

occupied by tenants who were eligible for HUD rental assistance. For any "formerly unsubsidized" property, HUD must survey the tenants' incomes, and if HUD determines that any tenants are eligible for--although not necessarily receiving--HUD rental assistance, a commensurate number of units must be preserved. If the survey finds that no tenants are eligible for rental assistance, the property may be sold without preservation requirements.

Exceptions to Section 8 Requirements

Current housing law provides for some exceptions to the Section 8 requirements, but these exceptions are limited. The law provides that, in some cases, the requirement to preserve units may be waived or an alternative form of assistance may be used to preserve the required number of units. Specifically, the law provides for the following exceptions:

- If the property was "formerly unsubsidized" and HUD can demonstrate that the property is located in a geographic area where adequate affordable housing is available, preservation requirements may be waived. However, any eligible tenants residing in the property would receive rental assistance for a renewable contract period of 5 years. HUD has not yet used this exception, authorized in the National Affordable Housing Act of 1990, because HUD has been delayed in issuing implementing regulations. Moreover, HUD officials have estimated that only about 3,600 units-- 11 percent of the units that need to be preserved-- would qualify to be sold under this exception. However, HUD estimates that, when its regulations are finalized and implemented, the use of this exception to the Section 8 requirement could lower the amount of Section 8 funding needed to dispose of the inventory from \$3 billion to about \$2.8 billion.

- If extreme circumstances exist that render it imprudent or unreasonable to preserve the property for use by low- to moderate-income tenants, the preservation requirements may be waived. For example, preservation requirements may be waived if the property is uninhabitable because of environmental factors or if rehabilitating the property would not be cost-effective. However, in the legislative history of the Housing and Community Development Act of 1987, the Congress admonished HUD against using waivers improperly to avoid preservation. As a result, according to HUD officials, HUD has been cautious in using this kind of exception. In fiscal year 1992, HUD used no such waivers.

-- HUD may also use an alternative whereby units are preserved but without using Section 8 funding. Through this alternative, HUD preserves units by lowering the sales price of the property in return for a commitment by the new owner to rent a specified number of units at reduced rents. However, if rents are reduced on too many units, operating the property will not be financially feasible. Therefore, this alternative to Section 8 funding works only when few units in a property need to be preserved. In fiscal year 1992, HUD disposed of only 2 properties using this method, although in 1993 HUD expects to dispose of 10 properties using this approach.

Applying Current Law to HUD's Inventory Results in Huge Section 8 Needs

When the preservation goal of current housing law is applied to HUD's large inventory of multifamily properties, a huge need for Section 8 assistance--ranging from \$2.5 billion to \$3 billion--results. As stated earlier, HUD headquarters officials estimate that disposing of the Department's beginning fiscal year 1993 inventory of 441 properties would require preserving 31,200 units. Preserving this number of units for 15 years would create a need for about \$3 billion in project-based Section 8 subsidy. HUD field offices however estimated a lower number of units that need to be preserved. Using the field office estimate of preservation needs results in a Section 8 subsidy need of about \$2.5 billion.

To evaluate HUD headquarters' estimate of the Department's preservation needs, we asked HUD regional and field staff to (1) verify the data that HUD headquarters had provided on the number of units in inventory as of October 1, 1992, and (2) to provide an independent estimate of how many units would need to be preserved under current housing law. In so doing, we gathered data from 30 HUD regional and field property disposition officials who currently have direct responsibility over the entire nationwide multifamily inventory. These officials told us that about 450 properties with about 69,800 units were in inventory as of October 1, 1992. HUD headquarters officials attribute the slight differences in the number of properties to having properties in inventory as of October 1, 1992, for which data had not yet been entered into HUD's computer system.

While field office data on the total number of units in inventory are close to HUD headquarters' data, field office estimates of how many of those approximately 69,800 units need to be preserved for low- to moderate-income housing are somewhat lower than headquarters' estimates. Field officials estimate that about 26,000 units need to be preserved, compared with headquarters' estimate of about 31,200 units. This difference

occurred because some properties classified in HUD headquarters records as "formerly subsidized" were reclassified by the field officials as "formerly unsubsidized," when they applied current housing law to their knowledge of the properties. HUD headquarters officials point out that any questions about a property's subsidy classification are always resolved before the property is sold.

Because the field officials classified fewer properties as "formerly subsidized"--a category requiring 100 percent of the units to be preserved--and more properties as "formerly unsubsidized"--a category generally requiring fewer than 30 percent of the units to be preserved--the field officials' estimate of preservation needs was lower. Using the field officials' estimate of preserving about 26,000 units at a cost of \$6,508 per unit per year, about \$2.5 billion in Section 8 assistance is needed.

Information from the field officials shows that, of the 26,000 units needing preservation, about 16,000 are contained in 141 "formerly subsidized" properties. The remaining 10,000 units needing preservation are contained in 184 "formerly unsubsidized" properties. In total, 325 properties--over 70 percent of the inventory--contain some number of units that need to be preserved and therefore cannot be sold without Section 8 assistance.

For some of the properties requiring Section 8 funding, HUD may have had a Section 8 contract with the original owner of the property before the owner defaulted on the loan. In such cases, any Section 8 assistance remaining from the original contract may be transferred with the property when it is sold to a new owner. However, according to HUD officials, often most of the 15-year term of the Section 8 subsidy contract has expired, and new Section 8 funds would be needed to meet the 15-year preservation requirements.

HUD HAS NOT REQUESTED SUFFICIENT SECTION 8 FUNDING

While federal housing law imposes a preservation goal that would require as much as \$3 billion in Section 8 funding to dispose of the current inventory, HUD has not requested sufficient funding to meet this goal. For example, in fiscal year 1993, HUD requested \$110 million in Section 8 assistance for property disposition, and the Congress appropriated \$93 million. (See attachments I and II for the funding amounts in dollars and units that HUD has requested and received from congressional appropriations over the past 4 fiscal years.)

The primary reason why HUD has not requested sufficient Section 8 appropriations is linked to budgetary issues. As you know, under the Budget Enforcement Act of 1990, there is a

ceiling on the federal government's total discretionary budget authority. HUD must compete with other agencies for discretionary budget authority within that ceiling. HUD's programs have to compete within the department's total allowance of discretionary budget authority. In the current tight budgetary environment, HUD must make difficult decisions about how to allocate its budget request among its many programs. According to HUD officials, HUD's decisions about how to fund the Department's inventory of properties is affected by the fact that holding the inventory has a much smaller effect on HUD's annual discretionary budget authority than selling the inventory. This occurs for two reasons:

- The Section 8 funds that HUD requests to sell the properties count against HUD's discretionary budget authority. In contrast, the funds needed to hold the inventory come from FHA's General Insurance Fund, for which appropriations are mandated by law. As a result, the costs to HUD of holding the inventory do not consume any of HUD's discretionary budget authority.
- To ensure that sufficient appropriations would be available to meet the subsidy requirements over the 15-year life of the Section 8 contracts, the full 15-year subsidy necessary to sell the properties--as much as \$3.0 billion--would have to be appropriated in the budget year in which the properties were to be sold. In contrast, the cost of holding the properties--\$248 million in fiscal year 1992--comes out of FHA's General Insurance Fund and is obligated a year at a time for as long as HUD holds the properties.

HUD officials also stated that, in past years, HUD did not request the amount of project-based Section 8 assistance necessary to dispose of the inventory because the previous administration was philosophically opposed to project-based rental assistance. According to HUD, the previous administration favored assisting low- to moderate-income tenants by providing a tenant-based subsidy. Under a tenant-based subsidy, assistance is provided directly to the tenant, not to a specific project. The administration believed that tenant-based subsidies were a more cost-effective way of providing low-income housing and enhanced the ability of tenants to choose among housing arrangements.

In addition to favoring tenant-based subsidies, the previous administration also hoped to dispose of some of the multifamily inventory through a program called Homeownership and Opportunity for People Everywhere (HOPE). That program was intended to help low- to moderate-income people become owners of their housing units. However, in fiscal year 1992, HUD disposed of only one multifamily property through the HOPE program.

The current administration's budget proposal for fiscal year 1994 includes a request for \$256 million in Section 8 funding for multifamily disposition purposes--a \$146 million increase over HUD's fiscal year 1993 request. However, even if the Congress appropriated the full amount requested, HUD still would not have sufficient funding to dispose of its total multifamily inventory. HUD officials acknowledge this limitation but state that the 1994 budget request reflects the realities of funding activities under a limited budget. Moreover, HUD officials state that selling the current large inventory of properties in the upcoming budget year would require more trained staff than HUD has available. Therefore, HUD wishes to limit its request to the amount of Section 8 funds that it could effectively use within the budget year, given the limited number of staff available.

HUD INCURS COSTS WHILE
HOLDING THE INVENTORY

While holding the multifamily inventory, HUD incurred operating and debt service expenses of about \$248 million in fiscal year 1992. These costs result from the difference between property revenue, which amounted to about \$81 million, and property expenses, which amounted to about \$329 million. While HUD holds the properties, the federal government pays the difference between property revenue and property expenses through the FHA General Insurance Fund.

During fiscal year 1992, HUD's inventory of multifamily properties brought in revenue of about \$81 million. Tenant rents accounted for \$71.6 million of this revenue, and miscellaneous sources, such as laundry and vending machines, accounted for the remaining \$9.4 million. Revenues on the properties are low because, in compliance with government housing guidelines, HUD cannot charge rents higher than 30 percent of an eligible tenant's income. Another reason why HUD receives low property revenue is that occupancy is reduced when HUD takes units out of service to repair them.

During this same period, expenses on these properties totaled about \$329 million. These expenses included (1) about \$198 million in operating expenses, (2) interest expenses of about \$4 million incurred on borrowed funds used to pay property operating expenses, and (3) interest expenses of about \$127 million on borrowed funds used to pay lenders when the property loans went into default.

When HUD takes over the management of a property, the property is often in poor physical condition because when the previous owner became financially troubled, maintenance of the property was deferred. As a result, in fiscal year 1992, HUD incurred \$64 million of its \$198 million operating expenses to repair and maintain the properties it manages. The remaining

expenses went for items such as real estate taxes, utilities, and payroll for advertising and managing the properties.

The interest expense that HUD incurred on the inventory properties totaled about \$131 million. This amount included about \$4 million in interest that accrued on funds borrowed for operating expenses. A much larger interest expense was incurred on the borrowed funds that FHA used to pay lenders when the property loans went into default. From the time that a claim is paid out until the time that these funds are either recovered from the sale of the property or written off as a loss, interest expenses continue to accrue. For the 441 properties that HUD held in inventory at the end of fiscal year 1992, FHA had paid out an estimated \$1.7 billion in claims to lenders. We estimate the interest costs that accrued on these claims during fiscal year 1992 amounted to about \$127 million.

In addition to operating and interest expenses, HUD estimates that managing the inventory involves about 128 full-time HUD staff. The salary expense for these staff amounts to about \$5.8 million annually.

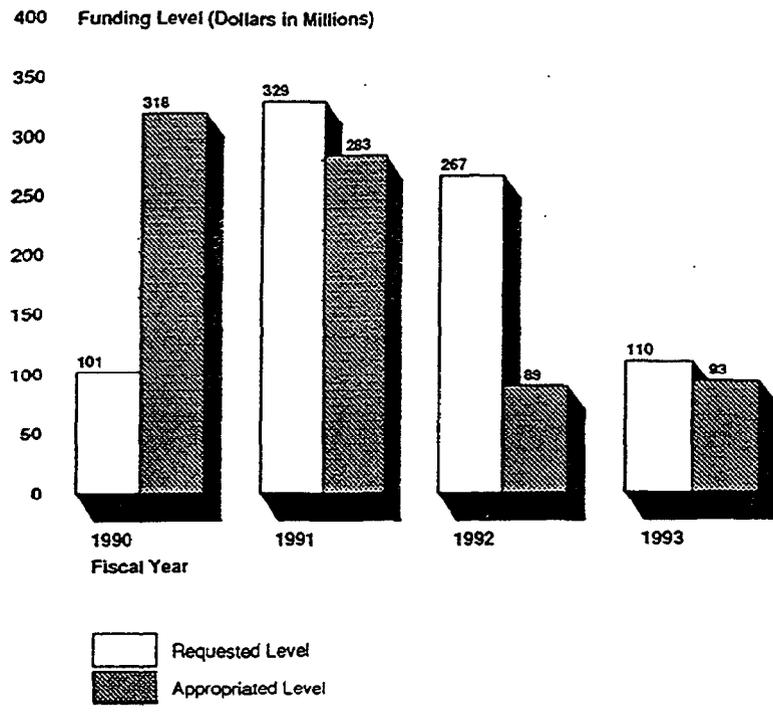
While HUD holds these properties, HUD pays the difference--\$248 million in fiscal year 1992--between property revenue and property expenses out of FHA's General Insurance Fund. However, even when the properties are sold, to achieve preservation, HUD will continue to pay a subsidy that represents the difference between property revenues and expenses. Currently this is done by using Section 8 rental assistance. Whichever funding source is used, the federal government pays for the shortfall.

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In summary, although we did not analyze whether it would be more cost effective to achieve the preservation of multifamily properties through selling them and using Section 8 subsidies or through HUD retaining the inventory and using the FHA General Insurance Fund to subsidize the properties, we do know that in either case the federal government will incur a significant cost. Currently, because of a lack of Section 8 rental assistance, preservation is being achieved by HUD's management of the inventory properties and funded through FHA's General Insurance Fund. In the absence of any action to change this situation, HUD will remain the landlord for a huge inventory of properties--a role that HUD was never intended to play nor has it been adequately staffed to fulfill.

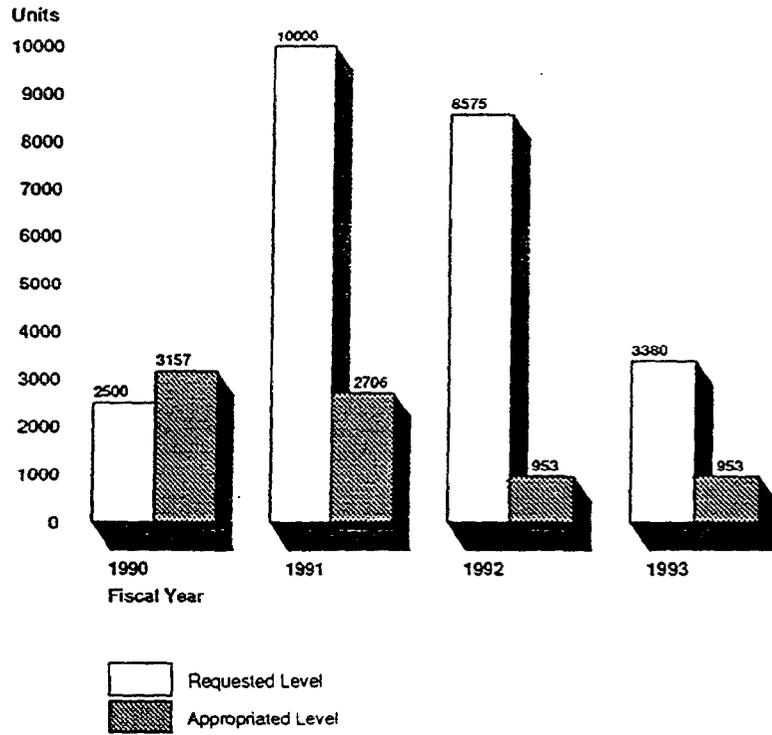
Mr. Chairman, this concludes my prepared statement. I would be glad to respond to any questions that you or any Members of the Subcommittee may have.

Figure 1: HUD Multifamily Property Disposition Section 8 Request and Appropriation Funding Levels, Fiscal Years 1990 - 93



Source: Prepared by GAO from Congressional Justifications, HUD, and U.S. Congress Conference Reports data.

Figure 2: HUD Multifamily Property Disposition Section 8 Request and Appropriation Levels in Units, Fiscal Years 1990 - 93



Source: Prepared by GAO from Congressional Justifications, HUD, and U.S. Congress Conference Reports data.



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