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HOUSING ISSUES

The Housing and Community
Development Act of 1994

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Economic Development Division



Mr. Chairman and Members of the Committee, thank you for giving me the opportunity to be here today to discuss H.R. 3838, the Housing and Community Development Act of 1994. As agreed with your office, I will focus my comments on aspects of the bill on which GAO has either completed or is in the process of completing work. Some of this work has been carried out at your request, Mr. Chairman, and some has been performed for other requesters who have given us permission to discuss it with you today. Because this statement is based, in part, on ongoing work, some of the results we present are preliminary.

The aspects of the bill that I will discuss relate to (1) default prevention for Community Development Block Grant loans; (2) the structure of and funding for the McKinney Act's homeless assistance programs; (3) the merger of the Department of Housing and Urban Development's (HUD) section 8 tenant-based certificate and voucher assistance programs; (4) the reamortization and refinancing of the Farmers Home Administration's (FmHA) rural housing loans; and (5) the disposition and loan management of HUD's multifamily assets.

In summary, H.R. 3838 addresses a number of problems that we have identified in our work. For example, it contains provisions that could reduce the potential for defaults or foreclosures in three government-sponsored loan programs--HUD's insured multifamily loans, HUD-guaranteed Community Development Block Grant loans, and FmHA's rural housing loans. It would improve HUD's efficiency in providing assistance to lower-income households by merging the HUD tenant-based certificate and voucher assistance programs. It also authorizes increased funding for homelessness assistance programs. This funding could help fill the gap between need and the programs' capacity to help the homeless.

Our work, however, has also identified several factors that the Committee should be mindful of as it considers this legislation. One important issue that affects both the proposed merger of the certificate and voucher assistance programs and the homelessness assistance programs is how the programs can best be structured to meet the needs of program recipients while minimizing administrative burdens on HUD staff and program recipients. Furthermore, our work has pointed out the usefulness of congressional monitoring of both the Community Development Block Grant and HUD's multifamily loan programs to ensure that continued delinquencies, defaults, and foreclosures do not threaten the programs' effectiveness.

I would now like to discuss our work in each the five areas I mentioned and comment on how H.R. 3838 would address the problems we found.

COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM

Mr. Chairman, I would like to begin by discussing the proposal in H.R. 3838 to establish new grants to be used in connection with section 108 loan guarantees under the Community Development Block Grant (CDBG) program. We believe these new grants, together with improved monitoring, should help lessen the incidence of defaults on these guaranteed loans.

As you know, several weeks ago GAO reported on the CDBG program, as required by the Housing and Community Development Act of 1992 (P.L. 102-550).¹ One thing we found is that the section 108 loan guarantees are important to local communities' funding of economic development activities, particularly for larger projects that require more funds than are normally available through CDBG grants.² Unlike the CDBG grants, section 108 loan guarantees tend to be used by communities more for economic development than for other purposes. For example, communities committed about 51 percent of their section 108 loans to economic development in fiscal year 1992, while entitlement communities (generally cities and urban counties) have consistently spent 10 to 14 percent of their CDBG grants for economic development each year since 1984.

As you are well aware, Mr. Chairman, defaults on CDBG loans have persistently been identified as a problem by HUD's Inspector General. While no established acceptable default rate has been established for CDBG economic assistance loans, a higher than normal rate might be expected because such loans are usually made to businesses that cannot obtain private financing and that often are located in distressed areas that have high crime rates. Most of the Inspector General's findings have involved loans that communities make using CDBG grant funds, but notable defaults have occurred on loans guaranteed by HUD under the section 108 program.

H.R. 3838 could help reduce the likelihood of defaults on these loans by authorizing HUD to use unspent funds recovered from the Urban Development Action Grant program to provide additional grants in conjunction with the section 108 loan guarantee program. These additional grants would likely help ensure the financial soundness of projects benefitting from the section 108 loans. The grants may also encourage more communities to use the loans and

¹Community Development: Block Grant Economic Development Activities Reflect Local Priorities (GAO/RCED-94-108, Feb. 17, 1994).

²Communities and states that receive CDBG grants can, under section 108 of the Housing and Community Development Act of 1974, apply for additional financing in the form of loans. Under this program, HUD guarantees notes issued by grantees for up to five times their current year's CDBG grant.

thereby result in more widespread use of the CDBG program for economic development activities. To date, this use has been concentrated among a limited number of grantees. However, because section 108 loans tend to involve larger amounts and the local communities are responsible for repaying the guaranteed loan by using future CDBG allocations, defaults can have a seriously detrimental effect on the grantees' CDBG activities. We therefore recommended that HUD assist the Congress in monitoring the seriousness of the default situation by starting to include in its annual CDBG report to the Congress data on delinquencies and defaults that it has begun to collect from grantees.

Our report also noted that CDBG-funded economic development activities, including section 108-funded projects, can play a significant role in helping communities carry out their economic revitalization strategies. However, without a comprehensive set of performance measurements, it is difficult to evaluate how effective these activities are. Our report identified numerous measurements that a community can use to evaluate local economic development initiatives. These indicators of effectiveness--which should be community specific--could measure one or more of the following outcomes: (1) the number, cost, targeted population, and types of jobs funded; (2) the increases in the community's tax base; (3) the leveraging of public and private funds relative to the CDBG investment; (4) the level of loan defaults; (5) the creation of needed essential services and facilities; and (6) the types and sizes of businesses assisted. In addition, although methodologically difficult, indicators that attempt to measure CDBG's contribution to an overall effort to revitalize a neighborhood could be formulated. Regardless of what performance measurements are used, it is important that they reflect the overall goal of the CDBG program, which is principally to benefit low- and moderate-income persons. Our report did not recommend that HUD establish performance measurements because we believe that such measurements can best be formulated by local grantees. However, we noted that HUD has the opportunity to help grantees define the measurements that would serve them best.

PROGRAMS UNDER THE STEWART B. MCKINNEY HOMELESS ASSISTANCE ACT

Another matter that I would like to discuss concerns provisions of H.R. 3838 that would reauthorize and increase funding for the McKinney Act's homelessness assistance programs. Within the next few weeks, GAO will be publishing the results of a comprehensive study on these programs that was requested by the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing, and Urban Affairs. This study assesses the local impact of McKinney Act programs via comprehensive case studies in the cities of Baltimore, St. Louis, San Antonio, and Seattle. The preliminary results from this work indicate that homelessness continues to be a serious problem that requires additional federal resources. Our work also developed information

that the Committee may find useful in evaluating the differences between H.R. 3838 and proposals made in the President's budget.

Extensive input from a wide range of those involved in assisting the homeless (federal, state, and local government officials; nonprofit service providers; and national researchers) led us to the inevitable conclusion that the need greatly outstrips the current capacity of available assistance programs. Local experts expect homelessness to remain a serious problem and are looking to the McKinney programs for additional resources to help them fill service gaps, particularly in the areas of prevention, longer-term housing, and comprehensive services to help the homeless achieve independent living. Both H.R. 3838 and the President's budget call for substantial increases in McKinney program funding, which should help. However, these experts were quick to point out that the McKinney programs should not be expected to make up for serious shortcomings in mainstream assistance programs for low-income people, which are supposed to form the "safety net" against becoming homeless. They believe the mainstream programs also must be expanded and made more accessible to the homeless to significantly improve the current situation. In this regard, we noted that the President's budget proposes to create 15,000 5-year rental assistance certificates to move homeless families from temporary shelters to permanent rental housing.

Some of the local service providers, especially those participating in more than one McKinney Act program at the same time, have found funding application and record-keeping requirements burdensome and to some extent duplicative. Some providers believe that the McKinney programs should be further consolidated to streamline their administration--a position endorsed by HUD and encompassed in the "continuum of care" approach proposed in the President's budget. This approach would fold many of HUD's McKinney Act programs into a comprehensive formula grant program with the intent of giving communities greater flexibility to focus McKinney program resources on their particular needs. Some experts, however, maintain that the current mix of categorical programs (as continued in H.R. 3838) better targets services to the varied needs of the homeless and precludes some needs getting lost in competing demands for scarce resources. Some experts also believe a formula grant approach might merely spread limited resources too thin to be effective. Another potential problem is the difficulty of devising an allocation formula that reflects relative need. As you know, HUD was unable to establish such a formula in response to the requirements in the 1990 McKinney amendments act.

Our forthcoming report also notes the possible negative impacts related to the withdrawal of appropriations in fiscal year 1994 for the Interagency Council on the Homeless. While HUD is providing funds to a successor organization formed as a working

group of the Domestic Policy Council, there is some question whether this group will be able to sustain the Interagency Council's former level of communication of information to the homelessness assistance community across the nation. This is a function we believe will become increasingly important over the next few years as many McKinney program evaluations are completed and yield information on what service strategies work best. We are pleased to see that H.R. 3838 reauthorizes funds for the Council.

PROPOSED MERGER OF THE SECTION 8
CERTIFICATE AND VOUCHER PROGRAMS

Mr. Chairman, I would like to turn now to the proposed merger of the section 8 certificate and voucher programs contained in H.R. 3838. In 1989, we issued a report³ that advocated merging these two assistance programs and we continue to support such action. Moreover, others, including national organizations representing owners and housing agencies, have also urged that the two programs be unified, as has the administration. However, Mr. Chairman, several key issues associated with a merger would need to be addressed, not the least of which is the capacity of HUD and the housing agencies to effectively carry it out.

A merger of the certificate and voucher programs should benefit HUD, housing agencies, private owners, and the approximately 1.3 million households assisted through these two programs. Under a merger, HUD and the housing agencies would have one program to administer rather than two and should have fewer administrative record-keeping requirements. In addition, private owners should no longer have to meet different requirements for renters receiving assistance through different programs. Finally, similar assisted households should be treated similarly in the housing subsidies they receive and their choice of housing under a merged program.

While there is widespread support for merging the two programs, there is less agreement on the provisions that a merged program should embody. We believe that there are five major issues that must be resolved in merging the programs: (1) the bases on which the housing subsidy is calculated (fair market rents or the payment standard approach⁴), (2) whether to include a shopper's

³Rental Housing: Housing Vouchers Cost More Than Certificates but Offer Added Benefits (GAO/RCED-89-20, Feb. 16, 1989).

⁴A subsidy benchmark, set by public housing agencies, which may not be less than 80 percent of the fair market rent for the applicable housing market.

incentive,⁵ (3) whether to provide budget authority for contract amendments when actual subsidy costs are greater than anticipated, (4) how to minimize the impact on HUD and housing agencies of a transition to a merged program, and (5) ensuring that HUD has the organizational capacity to carry out a merger. While I am prepared to answer your questions concerning any of these issues, I would like to focus my remarks today on the latter two, which have had little public discussion to date.

Effects of a Transition to a Merged Program

If the Congress decides to merge the two programs, whatever approach it adopts will require considerable effort on the part of HUD and the housing agencies. For example, the Congress could dissolve the certificate and voucher programs simultaneously and require HUD to provide housing assistance for all households under the requirements of a new "merged" program. This approach would likely require a considerable short-term effort by HUD field offices to merge about 30,000 existing contracts with over 2,500 housing agencies and educate these agencies about new program requirements. Also, the housing agencies would have to make considerable efforts to (1) educate tens of thousands of housing owners and gain their acceptance of new program rules, (2) educate about 1.3 million assisted households about new program requirements, and (3) establish unified record-keeping and accounting systems.

Alternatively, if the Congress adopted a gradual merger approach as existing housing contracts expire (as envisioned in H.R. 3838), HUD would be required to run three separate programs (the certificate, the voucher, and the merged programs) until existing contracts expired, around 2003. This approach would exacerbate the difficulties involved in administering multiple programs for both HUD and the housing agencies, since it would entail three--instead of two--sets of program requirements. However, it would limit the effort by HUD and the housing agencies at the outset, since it is a gradual approach.

Ensuring Organizational Capability

HUD's organizational structure has been criticized for fragmentation, lack of accountability, and overlapping authority. Because a merger would likely require considerable effort by HUD to complete the actions mentioned above, policymakers would need to ensure that HUD's staffing was appropriate and was organized so that a merger could be successfully carried out with little or no

⁵A provision which allows assisted households to contribute less than 30 percent of their income toward rent if they successfully "shop for" acceptable housing that rents for less than the payment standard.

adverse impact on the section 8 rental assistance program or on other agency activities.

As you know, we have recently designated HUD as a high-risk agency, in part, because of an organizational structure that blurs accountability, inadequate information and financial systems, and staff without the skills to effectively manage programs. The Office of Management and Budget (OMB) has also designated HUD at risk for its inability to ensure efficient and effective use of resources for achieving program results, while minimizing program risk and susceptibility to fraud, waste, and abuse. While both our and OMB's designations of high risk are agencywide, given these historical inadequacies, HUD should be in a position to demonstrate that it can effectively carry out a merger before it is required to undertake it. In this vein, the Secretary of HUD announced a reorganization to correct organizational problems in December 1993. An implementation strategy is scheduled to be developed by September 30, 1994.

REAMORTIZING AND REFINANCING FMHA LOANS

I would now like to now discuss H.R. 3838's proposed amendment to allow the reamortization and refinancing of section 502 Farmers Home Administration housing loans. We began discussing this issue with housing advocacy groups and FmHA last fall and are currently working on a request from the Chairman, Subcommittee on Information, Justice, Transportation, and Agriculture, Committee on Government Operations, to examine the extent of the problem and the budgetary impacts of allowing reamortization/refinancing within the program. Although we have not yet completed the budgetary aspect of our work, the preliminary results from our work indicate that the regulatory prohibition against reamortization/refinancing results in the customers of FmHA's section 502 program paying interest rates significantly higher than rates available to households in the private sector. The regulatory prohibition exists primarily because FmHA officials interpret the current legislation as requiring refinancing be counted as a new loan, and they do not want to limit the amount of new loans that could be made during the year. Also, FmHA officials believe that refinancing or reamortization authority would conflict with its goal of encouraging graduation to private credit.

In evaluating the scope of the problem, we found that FmHA's portfolio of single-family section 502 loans has a large percentage of mortgages with high interest rates when compared to rates available to new FmHA borrowers or those available to households in the private sector. For example, as of September 30, 1993, over 75 percent of FmHA's \$18.7 billion portfolio (about 600,000 loans) was at rates of 8 percent or higher. The current mortgage interest rate available to new FmHA borrowers is about 6.5 percent; private market rates are 7 to 7.5 percent. Furthermore, about 49,000 loans (over \$1.1 billion worth), are paying interest rates of 13 percent

or higher. While many loans are receiving some amount of interest credit subsidy, over 400,000 FmHA borrowers with total unpaid principal loan balances of over \$6.4 billion are currently receiving no subsidy at all, including 14,760 loans paying interest rates of 13 percent or higher.⁶

Mr. Chairman, while we have not yet completed our analysis of the budgetary impact of allowing the refinancing and/or reamortization of section 502 loans, we have found some positive outcomes that may offset the impact of the government's receiving reduced interest payments.

- Since lower interest rates reduce monthly payments, refinancing or reamortizing existing loans should result in decreased delinquencies and foreclosures. In addition, the lower mortgage payments would increase households' disposable income, which they could spend in their local communities, making the communities economically stronger.
- Reducing interest rates will reduce the number of FmHA customers who are receiving interest credit subsidies. In fiscal year 1993 these subsidies amounted to about \$600 million. Reduced rates will also reduce the associated high servicing costs involved in performing interest credit checks. While the interest credits reduce the effective interest rate a homeowner pays, it also affects homeowners' wealth because recapture accounts are established to record the interest credits that the households receive. Homeowners are required to pay back a portion of the recapture account to the government upon sale of the property.
- As compared to a refinancing agreement that requires a new loan with associated closing costs, we believe that reamortizing an existing loan to a lower interest rate without changing the other loan terms, such as the life of the original loan, will minimize paperwork costs and best benefit the borrower.

One complication of allowing blanket reamortization or refinancing authority is the impact on "graduating" borrowers to the private sector. The section 502 program is designed to be a temporary source of credit for low-income borrowers. As such, FmHA is required to graduate qualified borrowers to private lenders when the borrowers are financially able. However, according to FmHA

⁶An interest credit subsidy reduces the homeowner's effective interest rate, thereby reducing the amount of the monthly mortgage payment. Payment assistance in the form of interest credit subsidies is granted to eligible borrowers whose confirmed income is below the FmHA published limits. The amount of subsidy is based on the borrower's verified income, real estate taxes, and property insurance.

officials, the agency cannot force its customers to graduate because most U.S. attorneys will not back efforts to foreclose on current borrowers for refusing to graduate. This conflict of mission aspect needs to be worked out between the Congress and FmHA.

In connection with the specific proposal in H.R. 3838, I have a few comments.

- The regulatory prohibition against refinancing is in place because FmHA interprets the present legislation as requiring that refinanced loans count as new loans, thereby reducing the number of new borrowers who can be assisted. However, according to USDA's Assistant General Counsel, the amendment as currently written would not solve the problem of having to use current year funds.
- Any amendment to clarify refinancing/reamortization policy should specify the availability of the program to current as well as delinquent borrowers. Limiting an amendment to covering delinquent borrowers would create an incentive for current borrowers to become delinquent in order to obtain lower interest rates.
- The proposed amendment limits the reamortization benefits to a 3-year period. If this means the borrowers' payments will go back to the original loan rate after 3 years, the result will be an administrative ordeal for FmHA and a financial one for the customers.

LOAN MANAGEMENT AND PROPERTY
DISPOSITION OF HUD'S MULTIFAMILY ASSETS

Finally, as we previously reported to you in our May 1993 testimony⁷ and discussed with your staff in briefings on two ongoing assignments, there has been an increasing problem with HUD's ability to dispose of and manage its inventory of multifamily properties and mortgages. H.R. 3838, as well as other bills introduced in the Congress last year, provide frameworks for addressing these problems. In our view, prompt action on this legislation is needed. While the bills are similar in a number of respects, they differ in the extent to which they specifically require that properties be preserved after their disposition as rental housing for lower-income families.

⁷Multifamily Housing: Impediments to the Disposition of Properties Owned by the Department of Housing and Urban Development (GAO/T-RCED-93-37, May 12, 1993).

The inventory of HUD's multifamily assets is made up of three main components--(1) foreclosed multifamily properties ("HUD-owned properties"), (2) assigned mortgages ("HUD-held mortgages"), and (3) insured mortgages.⁸ The numbers of HUD-owned properties and HUD-held mortgages have increased substantially over the past few years. Specifically, the HUD-owned property inventory increased from about 10,000 units to about 31,000 units between fiscal years 1990 and 1993. Another 38,000 units are in the process of foreclosure. Since 1989, the number of HUD-held mortgages has increased by about 50 percent. As of July 1993, HUD held 2,432 mortgages. In addition, a substantial number of insured mortgages are at risk of default. In fiscal year 1992, HUD established a loan loss reserve of \$11.9 billion to cover estimated losses from its \$43.6 billion portfolio of insured mortgages.

I will now further discuss the management and disposition of HUD's multifamily assets.

Management of HUD-Held and Insured Loan Portfolios

According to HUD, a number of factors have led to the problems with its insured and HUD-held loan portfolios. These factors include the economic and tax consequences of the 1980s recession and the 1986 Tax Reform Act, the age and condition of the properties, and weaknesses in HUD's loan management capabilities. As of July 20, 1993, 2,432 mortgages with a total unpaid principal balance of \$7.45 billion had been assigned to HUD. While slightly more than half of the loans were delinquent, the delinquent loans represented about \$6 billion of the unpaid principal--or 80 percent of the total unpaid principal balance. In addition, 322 of the delinquent loans were either in foreclosure or had been recommended for foreclosure.

Furthermore, the potential exists for a far greater number of insured loans to default and for additional losses to be sustained by the insurance funds. As of September 30, 1992, HUD had insurance-in-force on over 15,000 multifamily loans with a unpaid principal balance of about \$43.6 billion. According to the Federal Housing Administration's fiscal year 1992 financial statements, as audited by Price Waterhouse, a substantial portion of these loans are at risk of default. In anticipation of these future losses,

⁸The Federal Housing Administration (FHA) provides insurance to lenders to protect them from financial losses stemming from a borrower's default on a multifamily mortgage. When a default occurs, a lender may assign a mortgage to HUD, file an insurance claim, and obtain the claim amount from HUD. HUD, generally, will try to bring the defaulted loan current; but if the loan cannot be brought current, HUD may foreclose on the mortgage. HUD will try to sell the mortgage at foreclosure or else the property will end up in its inventory.

HUD increased its loss reserves--the net amount in present dollar terms that HUD expects to lose when insured loans default--to \$11.9 billion. This estimate assumes that properties that currently receive subsidies will continue to receive them in the future.

H.R. 3838 contains several provisions that HUD believes are needed for it to more effectively carry out its loan management functions and reduce the potential for future assignments and foreclosures. These provisions are similar to those in S. 1299. According to HUD, among the most significant provisions in the bills are those governing the sale of HUD-held mortgages. The legislation restates the conditions under which HUD can sell subsidized mortgages and clarifies HUD's authority to sell unsubsidized mortgages. HUD officials believe that decreasing the number of HUD-held mortgages through a sale will relieve some of the workload for its loan servicing staff and will also reduce losses to the insurance funds. While the bills' provisions should help HUD improve the management of its HUD-held loan portfolio, given the serious nature of the problem, it is important that HUD's success in reducing delinquencies and avoiding foreclosures be closely monitored.

Disposition of HUD's Multifamily Properties

The growth in the HUD-owned inventory stems from provisions in the Housing and Community Development Act of 1987 that require HUD, upon disposition, to ensure the goal of preserving many of the units in its multifamily inventory as affordable rental housing for low- to moderate-income people for 15 years. Specifically, HUD is mandated to preserve all units in "subsidized"⁹ properties and those units occupied by low-income tenants in "unsubsidized" properties. To ensure that these units are available and affordable to low-income people, HUD generally uses a federal rental subsidy program, known as project-based section 8 assistance.¹⁰ However, because of the limited amount of section 8 funds available to meet these section 8 requirements, HUD has been able to dispose of only a relatively small number of multifamily properties in recent years.

⁹A "subsidized" property is one that was receiving a subsidy--such as a below-market interest rate loan or other rental payment assistance--or Housing Assistance Payments (such as project-based section 8) for more than 50 percent of its units before HUD acquired it. An "unsubsidized" property was not receiving any subsidy or was receiving a Housing Assistance Payment for less than 50 percent of its units.

¹⁰Under this program, HUD pays the project owner the difference between what a tenant can afford to pay (30 percent of income) and the actual rent for the unit.

H.R. 3838, as well as H.R. 3400 and S. 1299, which passed the House and Senate respectively last year, provide frameworks for addressing the problems of HUD's disposition of multifamily properties. Each of these bills recognizes that the disposition of properties requires a careful balancing of several goals, including (1) protecting the federal government's financial interests, (2) preserving housing so that it remains affordable to low-income people, and (3) preserving and revitalizing residential neighborhoods. However, they differ in terms of the extent to which they mandate preserving properties and protecting tenants.

In his statement before the Committee on February 24, 1994, the HUD Secretary cited the importance of revising the current legislative requirements for multifamily property disposition. We agree with his assessment that the need for prompt action on this matter is critical. The problems we identified with HUD's multifamily property disposition and loan management were a major factor in our recently designating HUD as "high risk."

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

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