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Resources, Community, and
Economic Development Division

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November 17, 1994

The Honorable Barbara Mikulski
Chair, Subcommittee on VA, HUD
and Independent Agencies
Committee on Appropriations
United States Senate

Dear Madam Chair:

The owners of about 3,600 multifamily housing projects containing approximately 385,000 housing units are, or over the next few years will be, eligible to prepay their mortgages. Prepayment of these mortgages could result in the termination of federal use restrictions that set aside a number of units in each project for lower-income households.[1] Concerned that prepayment could result in the loss of these units for lower-income households, the Congress established a preservation program that authorizes financial incentives to those owners who agree to extend the use restrictions or transfer the property to a qualified purchaser who will, in turn, maintain the project's use restrictions.[2]

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[1]Most eligible projects were developed during the 1960s and 1970s with mortgages subsidized by the federal government under section 221(d)(3) of the National Housing Act or section 236 of the Housing and Community Development Act of 1968.

[2]The type and amount of incentives available to a particular project depend on whether an owner elects to extend or transfer a project's use restrictions. Incentives can include a number of financial arrangements, such as funding capital improvements (repairs), increasing federal rental assistance, and providing the owner with access to a portion of the project's equity though the issuance of a second mortgage.

Several months ago, we reported to you information on the status of those projects eligible for preservation incentives.[3] To address concerns you raised about how the Department of Housing and Urban Development (HUD) estimates its preservation program's costs, we agreed to examine a computer model that HUD uses for this purpose. Specifically, our objective was to determine the model's ability to make reliable annual budget estimates for the preservation program.

In summary, we found that the model has not been able to successfully estimate the preservation program's annual funding needs. The primary reasons for this weakness are that the model has not been able to accurately predict when project owners will apply for preservation incentives and how long it will take these owners to complete HUD's review process once they apply. HUD's efforts to correct this problem by modifying the model's assumptions have had limited success. This limited success has occurred because decisions on whether and when to participate in the preservation program are at the sole discretion of project owners and may be influenced by a variety of factors (such as property ownership arrangements) that may not be known to HUD. Furthermore, the time it takes to complete the preservation process varies widely, depending, in part, on whether owners decide to extend or transfer a project's use restriction. Because of these problems, HUD has, since fiscal year 1994, relied less on the model and more on actual program experience to estimate annual budget costs. In fiscal year 1995, rather than using the model, HUD estimated its preservation budget costs using data based on actual program experience, including when owners applied for incentives and how long it took them to complete the preservation process.

Because the program's actual cost data for fiscal years 1994 and 1995 were not yet available at the time of our review, we could not determine whether the budget estimation process that HUD used for these years resulted in more realistic cost estimates than had been achieved when HUD used the model.

BACKGROUND

Owners of certain multifamily housing projects developed with government assistance are eligible to prepay their mortgages after 20 years and remove

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[3]Multifamily Housing: Information on Projects Eligible for Preservation Assistance (GAO/RCED-94-177FS, Apr. 15, 1994).

low-income use restrictions that were placed on units in the projects as a condition of government assistance when they were developed. To prevent the loss of these units through prepayment, the Congress authorized on a temporary basis a preservation program in 1987 under the Emergency Low-Income Housing and Preservation Act (also known as title II or ELIHPA). Permanent authority was granted in 1990 when title II was amended by the Low-Income Housing Preservation and Resident Homeownership Act (also known as title VI or LIHPRHA). This preservation program is designed to ensure that most of these units remained available and affordable to lower-income families and that current owners are fairly compensated for agreeing to extend the use restrictions for the remaining useful life of the project. As an inducement to maintain the use restrictions, the law authorizes certain financial incentives for those owners who extend the use restrictions or transfer the property to a qualified purchaser who will, in turn, maintain the use restrictions.

Because of the potential costs associated with these incentives, the Senate Committee on Appropriations, in September 1990, directed HUD to provide it with a comprehensive assessment of the likely outcomes and long-term costs of preserving these projects for fiscal years 1991 through 1996.[4] To address the Committee's concerns, HUD developed a model that estimated a need for $6.2 billion to preserve an estimated 325,000 housing units over this period of time. The model also estimated that over a 20-year period, $27.5 billion (both estimates are in nominal dollars) would be required to fund preservation activities for an estimated 360,000 units.[5] HUD later revised the model to improve the quality of estimates on the basis of HUD's program experience and used the model to help estimate the program's annual costs. It is this revised version of the model that we assessed.

MODEL UNABLE TO ACCURATELY ESTIMATE THE PROGRAM'S ANNUAL FUNDING NEEDS

The preservation program's annual costs calculated by HUD's model have not been reliable. The model's inability to accurately estimate the program's annual costs is principally the result of problems in estimating

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[4]Senate Report 101-474 on the VA, HUD and Independent Agencies appropriations for fiscal year 1991, Sept. 10, 1990.

[5]HUD's results were relayed to the Committee in a report issued on Apr. 18, 1991, to the Chair of the Subcommittee on VA, HUD and Independent Agencies, Senate Committee on Appropriations.

when project owners will apply for preservation incentives and how long it will take HUD to process these applications. Because of this weakness, HUD has, in recent years, relied less on the model to estimate annual costs and more on the program's actual experiences.

Originally, the model was designed to assess the likely outcomes and long-term costs of preserving projects that were subject to prepayment and possible removal of the use restrictions. However, over time, HUD modified the model in an effort to help determine annual budgetary needs for the preservation program. This revised model is a series of computerized spreadsheets that estimates the annual cost of incentives needed by owners to maintain their projects as low-income housing units. In determining these costs, the model calculates the amount of preservation equity for each project on the basis of a number of property characteristics, such as mortgage payments, rental revenue, and various neighborhood features, such as local market rental rates.[6] If a project has a sufficient amount of positive preservation equity, the model assumes that the project owner will apply for participation in the program at some point in time. The model then calculates the cost of the financial incentives needed to maintain the project's use restrictions. In reviewing the model's ability to make these calculations, we found that the model's overall design, data, and key assumptions were reasonable and well founded.

However, as shown in table 1, the model has not been able to produce reliable annual budget estimates.

[6]Preservation equity is based on the difference between the project's outstanding federally assisted mortgage and the value of the project if it were converted to a market-based rental.

Table 1: Comparison of the Model's Estimated Funding Needs to the Actual Funds Reserved, Fiscal Years 1991-93

Dollars in thousands

	Fiscal year dollars		
	1991	1992	1993
Model's estimate	$253,000[a]	$146,000[a]	$633,000
Funds reserved[b]	$66,000	$274,000	$79,000

[a]These estimates were generated by the revised model; however, the budget estimates that HUD actually used for these years were derived from the original model.

[b]Once the Preservation Office earmarks financial incentives for a preserved project, the funds are considered reserved.

The primary reason for the unreliable budget estimates is that the model has not been able to accurately forecast when owners will apply for preservation incentives and how long it will take to approve their applications. These factors must be accurately estimated to determine the amount of appropriations needed to fund the preservation incentives in a fiscal year.

Initially, the model assumed that owners would apply for incentives on the date they were eligible--an assumption that soon proved to be incorrect. HUD has since modified this assumption and adjusted time frames so that the model now assumes owners will file a notice of intent to participate anywhere from the time a project is eligible to 36 months after its eligibility date, depending on whether the owner applies under title II or title VI.[7] The model then assumes that it will take anywhere from 10 to 24 months to completely process and approve the application, again depending on which

[7]Owners can file a notice of intent to participate in the program 24 months before the mortgage's 20th year. Once the owner is within the 24-month period, there is no time limitation or restriction as to when an owner can apply for program participation. However, once a notice is filed, title VI sets specific time frames under which the process must be completed.

title the project is processed under and the option selected by the owner.[8] Even with these changes, the model still has not been able to accurately estimate when an owner will apply for incentives and the year in which applications will be approved and the incentives received.

HUD officials in the Policy Development and Research Office who developed the model and the Preservation Division who use the estimates generated by the model, believe that the changes made to the model have had only limited success in improving the model's ability to accurately predict when owners will apply for preservation assistance. The success of the improvements has been limited because applying for incentives is at the sole discretion of the owner and can be influenced by a variety of factors that may not be known to HUD, such as property ownership arrangements and the property's value. We found that title II project owners who have actually filed their notices of intent did so from 24 months before the eligibility date to almost 70 months after the eligibility date. Estimating processing times has also proven to be difficult because of the variations in the actual time it takes projects to reach approval and secure incentives. We found that the time between when an owner filed a notice of intent until the project was approved ranged from 49 days to just over 4-1/2 years.

Although HUD officials recognized the difficulty of predicting when owners would apply for preservation incentives, they still used the model's estimate to formulate the preservation program's budget requests for fiscal years 1992 and 1993. They continued to use the model because HUD officials believed it was, at that time, the most reliable source available for determining the program's costs, since the Department lacked any extensive data on the program's actual experiences and processing time frames.

Beginning with the fiscal year 1994 budget submission to the Congress, HUD began to rely more on the program's actual experiences to estimate the annual costs. According to a HUD Budget Office official, the 1994 cost estimates had their origin in the model but have been subjected to interpretation and adjustments by housing program managers and policy officials. This modified cost estimate, in conjunction with information based on HUD's limited actual program experiences, allowed HUD to develop its

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[8]These options are (1) maintaining the project for lower-income use; (2) transferring the project to a nonprofit organization; (3) selling the project to a qualified purchaser who will maintain the low-income use restrictions; or (4) terminating the project's lower-income use restrictions.

1994 preservation budget costs. By fiscal year 1995, HUD officials told us they had gained enough experience with processing preservation applications that they were able to develop this fiscal year's budget on the basis of actual case experiences.[9] Because the program's actual cost data for fiscal years 1994 and 1995 were not yet available at the time of our review, we could not determine whether the budget estimation process that HUD used for these 2 fiscal years resulted in more realistic cost estimates than had been achieved when HUD used the model.

SCOPE AND METHODOLOGY

We reviewed HUD's revised version of the model used to estimate the funding needs of the preservation program. Specifically, our objective was to assess the model's ability to make reliable annual budget estimates for the preservation program.

We examined the budget estimates that HUD prepared using the model and compared them with HUD's expenditures for the preservation program in those years. We discussed the differences with HUD officials and examined the model to determine the reasons for those differences. Because the model consists of hundreds of data columns, formulas, and assumptions, we did not attempt to examine every data element or verify every formula and calculation. Rather, we focused on the completeness of the model's structure, examined what we found to be key data elements, and reviewed the logic of what we considered major assumptions, such as when owners will apply for participation in the preservation program and the time it takes to complete the preservation process.

To determine whether the model can reasonably estimate which projects have sufficient preservation equity to participate in the program and the cost of incentives needed for those who choose to participate, we (1) considered whether the cash flows assumed by the model accurately and completely represented the cash flows for a subsidized rental project and (2) determined the logic and accuracy of those variables, formulas, and calculations that we believed to be the most important in producing the model's forecasts.

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[9]The former Director of HUD's Preservation Division noted that regardless of the method HUD uses to arrive at its annual budget, the estimates are subject to change during the budget process because of various factors, such as budgetary ceilings and competing demands by other programs.

In testing the quality of data used by the model, we selected a random sample of 200 projects from HUD's data base of preservation-eligible projects--totaling about 3,600. We determined those data that were key in producing the model's estimates and asked HUD field office staff to provide these key data for our sample of projects. This information was provided by a mail-back questionnaire, and key data were supported with photocopied documentation. We received responses for 194, or 97 percent, of the sampled projects.

We performed our review from June 1994 to October 1994 in accordance with generally accepted government auditing standards. We discussed the information in this correspondence with HUD officials at the Office of Policy Development and Research, Office of the Budget, and Office of Housing's Preservation Division. They generally agreed with the information presented in this correspondence but suggested several minor technical clarifications, which we incorporated where appropriate. We are sending copies to the Secretary of HUD and the Director, Office of Management and Budget. Should you require more information, please call me at (202) 512-7631.

Sincerely yours,

Jim Wells

for Judy A. England-Joseph
Director, Housing and Community
Development Issues

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