

Mark-to-Market: A Fundamental Shift in Affordable Housing Policy

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Abstract

In October 1997, Congress enacted the Multifamily Assisted Housing Reform and Affordability Act (MAHRA), commonly referred to as the “mark-to-market” legislation. The most significant housing legislation in a decade, MAHRA seeks to cut Section 8 subsidy costs on about 4,000 properties, bringing rents into line with local markets. MAHRA provides a broad framework for resetting rents and resizing mortgages and answers many fundamental policy questions. The U.S. Department of Housing and Urban Development’s (HUD’s) evolving program rules will determine how the mark-to-market legislation will actually work, who will participate, and what will happen to the properties and their residents.

This article describes the legislation’s origins, major features, and properties affected and reviews the key policy issues. To illustrate the dynamics, three distinct implementation options are presented as thought experiments. This article also explores potential roles for nonprofit entities and concludes by reviewing HUD’s recently issued regulations.

Keywords: HUD; Policy; Multifamily assisted housing

Introduction

Congress enacted the Multifamily Assisted Housing Reform and Availability Act (MAHRA), or the “mark-to-market legislation” as it is commonly known, to preserve as much as possible of the existing stock of low-income multifamily rental housing benefiting from Section 8 assistance provided by the U.S. Department of Housing and Urban Development (HUD). This stock, which was created between 1968 and 1988 under various Section 8¹ and predecessor programs, now faces a number of challenges:

1. In many cases, rents have been allowed to rise well above local market levels, making the units very expensive for HUD to subsidize.

¹ Specifically, this refers to Section 8 of the U.S. Housing and Community Development Act of 1974.

2. Contracts between HUD and private sector owners are expiring now or will soon expire, which will impose unfeasible contract renewal costs on HUD, cause properties to default, or relieve owners of contractual obligations regarding rent levels and income limits—thereby decreasing the amount of affordable housing for low-income families.
3. Some properties are in need of repair and rehabilitation and continue to deteriorate physically, in some cases becoming a blight on the community. Many more properties are physically sound but aging and will need renovation or upgrades that may require a one-time capital injection.
4. The number and complexity of the apartments, programs, issues, and participants has become administratively demanding for HUD at a time when its human and financial resources have been reduced.

To address these issues, MAHRA, the most significant housing legislation in a decade, offers owners of eligible properties the opportunity to restructure their mortgages in a way that will (1) make their rents more consistent with local market rents and (2) lower the debt service on participating properties, thereby making the lower rents economically feasible. Successful implementation of the mark-to-market legislation will reduce ongoing Section 8 outlays by an estimated \$1 billion per year (Smith 1995), reduce the properties' continuing dependency on subsidy, and improve their market competitiveness. The program will impose a one-time cost to the U.S. Federal Housing Administration (FHA) insurance fund of approximately \$8 to \$12 billion. It will be implemented through the new HUD Office of Multifamily Housing Assistance Restructuring (OMHAR), which will delegate the day-to-day implementation of the program to participating administrative entities (PAEs). The PAEs will work with owners to create a mortgage restructuring and rental assistance sufficiency plan for each participating property. During 1996 through 1998, Congress authorized and HUD conducted a mark-to-market demonstration program.

The mark-to-market legislation represents an affirmative decision by Congress to disengage from the regulatory constraints and contractual obligations that resulted from the Section 8 production programs. Thus, to understand mark-to-market both as policy and as legislation, one must understand how the mark-to-market-eligible inventory was created and where it stands today.

Background on the portfolio²

The portfolio consists of two parts: (1) the “older assisted stock” of 700,000 apartments (about 450,000 of which now receive a Section 8 loan management set-aside [LMSA]) that was developed between 1968 and 1975 under the Section 236 and Section 221(d)(3) programs and (2) a “newer assisted stock” of another 675,000 apartments of Section 8 New Construction/Substantial Rehabilitation (NC/SR), developed under Section 221(d)(4) and its analogs, where rent increases were governed by Annual Adjustment Factors (AAFs) established by HUD. Section 8 NC/SR is further subdivided into (a) the “old regulation” cohort of 450,000 apartments built between 1977 and 1981, in which no limitations on cash distributions exist; and (b) the “new regulation” cohort of 225,000 apartments with generally longer Section 8 contracts and dividend limitations.

Among the older assisted properties, the central issue is typically the need for rehabilitation owing to deferred capital investment; for the newer assisted properties, the issues tend to be more financial in nature.

The discussion that follows outlines the origins of this inventory, its current status, and the considerations that led to the enactment of the recent mark-to-market legislation.

Origin of the FHA-insured multifamily inventory

The older assisted properties. Stimulated by the ambitious goals of President Lyndon Johnson’s Great Society, spurred by grim headlines of urban riots,³ and with the memory of the destruction of the infamous Pruitt-Igoe public housing development in St. Louis fresh in their minds, Congress enacted Section 236 in 1968 to stimulate development of privately owned, federally assisted housing and stepped up the production of housing for low-income elderly residents under Section 221(d)(3). Between 1968 and 1975, these two programs stimulated the development of approximately 700,000 mostly family-oriented affordable apartments throughout the country.

² Statistics in this section were compiled by Recapitalization Advisors, Inc., using a variety of HUD summaries prepared from 1995 through 1997.

³ The *Report of the National Advisory Commission on Civil Disorders*, issued in March 1968, called for vast expansion in the below-market interest rate program (Section 221[d][3]) and the rent supplement program (which evolved into Section 8) as well as the creation of a new interest-rate-writedown program (which was enacted later that year as Section 236) (Kerner et al. 1968).

Both programs sought to make possible lower rents through inexpensive financing. Under the Section 221(d)(3) Below-Market Interest Rate (BMIR) program, developers could obtain 3 percent loans; under Section 236, loans were at market (typically 7 percent) with an annual subsidy that brought the effective debt service down to the equivalent of a 1 percent rate. Below-market rents were maintained through budget-based rent increases. Treating the properties as if they were regulated public utilities, HUD approved rent increases only to the extent needed to cover increases in operating costs, keeping net cash flow after debt service flat and retaining any cash flow above a stipulated limited dividend in the property's residual receipts account.

In theory, because operating expenses comprised only a fraction of the total budget, the rental advantage—the gap between market rent and budget-based rent—ought to have expanded over time, and in the more successful properties, it did. But as the years passed, the budget-based approach also revealed several structural problems:

1. Budget-based rents are administratively demanding, placing heavy burdens on HUD.
2. The budget-approval process sometimes became adversarial between owner and regulator rather than making them allies in protecting the property and serving the residents.
3. Budget basing, with its consumer protection emphasis on rent restraint, has an inherent tension between affordability (keeping rents down) and property viability (raising them when needed), a tension that HUD often attempted to resolve (without much success) by favoring lower rents, thus slowly starving properties of capital. HUD also consciously encouraged deferral of reinvestment. Over time, the properties' market competitiveness declined.
4. Budget basing creates perverse incentives for the owner. Parsimony goes unrecognized, but profligacy is rewarded with higher rents (and, until HUD changed its formulas, with higher management fees).

In addition to these issues, changes in the national economic climate revealed another problem: expanding subsidy requirements. In 1974, the Middle Eastern oil embargo and the subsequent jump

in utility expenditures exposed many properties to default,⁴ risking huge losses to the FHA insurance fund.

In 1976 HUD and Congress responded by retrofitting properties built under the Section 236 and 221(d)(3) programs with a substantial new Section 8 LMSA,⁵ which addressed the short-term problem of expanding subsidy requirements by providing rental assistance to income-eligible tenants. But the long-term costs were great. Once LMSA was placed on a property, neither HUD nor Congress had any explicit sunset mechanism for dealing with it (that is, LMSA was renewed even if the property no longer needed it), and both owners and residents wanted to retain it. As a result, although less than 20 percent of the older assisted stock was originally supported with income subsidy, 65 percent of that inventory had become dependent on property-based Section 8 LMSA by the time it reached maturity.

The programs that produced the older assisted stock were predicated on the assumption that low financing costs would provide an enduring rental advantage and thus ensure ongoing project viability and increase its operating margins. What was learned from the unexpected operational and management problems that arose intermittently over time were two fundamental discoveries:

1. An inherent tension exists between making a property affordable to lower-income residents and making it economically viable. A budget-based rent structure places those goals in conflict on every decision.
2. Identifying and finding the resources to build affordable housing is straightforward; managing it over time is much more difficult.

⁴ The bind was particularly acute because, in general, residents bore the full brunt of the increases, and because their rents had been structurally reduced, the same dollar increase represented a larger percentage of total rent to them. (Imagine two identical apartments, one of which rents for \$400 and the other, benefiting from Section 236, for \$300. If each must impose a \$30 rent increase to cover higher utility expenditures, the market apartment must raise its rents 7 percent and the Section 236 apartments must raise rents 10 percent.) Thus, HUD field offices were faced with two unacceptable alternatives: (1) limit increases to what residents can afford, in which case maintenance must be deferred; or (2) raise rents to cover increased costs, only to see the residents—for whom the property was developed in the first place—forced to move out.

⁵ As originally offered by HUD in 1976, Section 8 LMSA was available only to properties that were not in default but could show that without Section 8, they would default, and with it, they would not. It was colloquially known as “bailout Section 8.”

The newer assisted properties. Recognizing the limitations of budget-based rents that reflected changes in operating costs, in 1976 Congress shifted to a different paradigm: providing Section 8 property-based housing subsidies based on market rent levels as estimated by HUD's fair market rents (FMRs) for respective metropolitan statistical areas (MSAs). To keep pace with rising costs, the level of subsidy would be adjusted automatically over time by an AAF.

The vehicles for offering this changed type of assistance were the NC/SR programs. These properties generally paired a mortgage insurance program (usually Section 221[d][4] and its analogs)⁶ with a long-term Section 8 contract covering all the apartments.⁷ In the NC/SR programs, a property's rents were pegged to baseline market levels that were established during the initial underwriting process. HUD provided property owners with Section 8 property-based assistance to cover the difference between market rents and what residents could pay. Long-term affordability was ensured through a 20-year contract between the property owner and HUD that guaranteed HUD assistance to all the apartments in the property for that period of time.

Initial rents were to be set at market levels. The new approach favored a hands-off automatic annual increase based on changes in market rents. The AAF was numerically applied to the previous year's rent to derive the next year's rent. With rents ostensibly tracking the market, presumably cash dividend limitations would not be required, so efficient operators would make more money.

Like its predecessor, the AAF program became highly successful, generating about 450,000 apartments from 1977 through 1981. Recognizing that the program's financial incentives were perhaps too strong, in 1979 Congress amended the program to build into the Section 8 contract a long-term dividend limitation. Another 225,000 or so "new regulation" Section 8 AAF apartments were built under the amended legislation. Although the program continued to stimulate production of affordable housing, it exposed a different, perhaps subtler, set of risks and distortions:

⁶ Section 220 was equivalent to 221(d)(4) in urban renewal areas, and Section 231 was equivalent to 221(d)(4) for all-elderly properties.

⁷ With this combination, it was generally easy to raise debt, which opened the further possibility of using FHA mortgage insurance as a credit enhancement to tax-exempt bonds sold by state housing finance agencies (HFAs). As interest rates rose in the late 1970s and very early 1980s, HFA financing became increasingly common.

1. Production of good housing in poor inner-city neighborhoods generally requires that initial rents be set higher than those in the local market. To make higher rents possible, HUD either expanded the definition of MSAs over which FMRs were computed or allowed properties' initial rents to be set above the local FMR by offering property owners up to four 5 percent rent premiums. As a result, many properties began operations with rents at 120 percent of FMR (or higher).
2. Under the Section 8 AAF program, rents that were initially set above market and increased by AAFs tended to remain above market.⁸
3. The program's beneficiaries protected their turf. Responding to the pleas of owners of Section 8 AAF properties, in 1987 Congress enacted Section 142(d), precluding HUD from implementing any AAF rent decreases to correspond with decreases in market rents.
4. The FMR rent-setting mechanism proved vulnerable to statistical inaccuracies and also to changes over time. The Section 8 AAF program originally calibrated rents to correspond to the 50th percentile (that is, median rent) for newly constructed properties. However, HUD's standard for FMRs was eventually changed to the 50th percentile for *existing* (that is, older) properties, then to the 45th percentile, and finally to the 40th. Thus, over time, the standard of comparison—and the FMRs—shrank in real terms.
5. As it became evident that property owners were realizing profits from the large and rising cash flows that result from above-market rents, the program's image and political support deteriorated.

The legislative change embodied in MAHRA was the result of the cumulative effect of the Section 8 program's unintended rent distortions. Legislative action was prompted by a number of factors, including the sudden and profound change in the makeup of Congress and the opportunity to renegotiate with property owners presented by the expiration of Section 8 AAF contracts.

⁸ Congress did include a provision requiring "comparability" in Section 8 AAF that was intended to ensure that rents increased only to the extent that they were not above comparable rents for unassisted properties—but Congress then mitigated this by allowing the "initial difference" (as the underwriting rent premium was known) to continue even over the comparable rent.

The inventory today

By late 1994, about 900,000 apartments were receiving property-based Section 8 subsidies under contracts scheduled to expire in the next seven years. As detailed in table 1, the inventory consists of two large clusters, the older assisted inventory of properties with budget-based rents and the newer assisted inventory whose rents were based on AAF.

Table 1. Inventory of HUD Multifamily Properties with FHA-Insured (or HUD-Held) Mortgages and Section 8 Contracts Expiring Soon

Category	Section 8 Inventory	Rents above Market	Description
Older assisted	450,000	75,000	Budget-based rents; tend to need rejuvenation
Newer assisted	<u>450,000</u>	<u>325,000</u>	Section 8 AAF, half of them all-elderly
	900,000	400,000	

Source: Author's estimates based on a variety of sources, primarily HUD records and financial analysis prepared by Recap Advisors.

A more detailed taxonomy of significant characteristics is presented in table 2, but a few highlights are worth noting.

The older assisted inventory. Originally the older assisted inventory consisted of about 700,000 or more apartments, but as the portfolio has aged, it has lost properties from both the bottom, in terms of economic value (through foreclosures), and the top (through prepayments, beginning in 1996). Today about 650,000 apartments remain in the older property-based Section 8–assisted inventory (of which 450,000 receive Section 8 assistance).⁹

Within this group is a subset of “postpreservation properties” (about 60,000 apartments) that were recapitalized between 1991 and 1997 under the Low-Income Housing Preservation and Resident Homeownership Act (LIHPRHA) program.¹⁰ Because LIHPRHA has been defunded and the owner's right to prepay restored, over the next two years another 25,000 to 40,000 of these apartments, generally

⁹ In total, there were about 650,000 Section 221(d)(3) and Section 236 apartments, but only 450,000 of them receive Section 8 LMSA, which was added incrementally to older assisted properties *after* their financing. These statistics were compiled by the author using a HUD database, available at www.hud.gov/fha/mfh/mfhsec8.html.

¹⁰ LIHPRHA was enacted in 1992 as part of the Cranston–Gonzalez National Affordable Housing Act to provide incentives to owners of older assisted properties to stay in HUD's programs and encourage sale of properties to tenants and non-profit entities.

*Table 2. Section 8 Mark-to-Market
Classification of the HUD Multifamily Assisted Portfolio*

	Older Assisted Portfolio	Newer Assisted Portfolio
Number of apartments involved	640,000	450,000
Percentage with above-market rents	15	90
Median rent today (percent of FMR)	90	130
Range of rents today relative to FMR	60–115%	90–175% (or more)
When developed	1968–1976	1977–1983
Type of construction	New construction or light rehab	New construction or substantial rehab
Most common locations	Inner city, near suburbs, some rural	Some inner city, suburbs, rural
Original rents relative to market	Usually 10–20% below	Usually 10–40% above
HUD financing programs involved	Section 221(d)(3) and Section 236	Section 221(d)(4) and related programs
Mortgage interest rates	Below market (3% or 7% bought down to 1%)	Market (7.5% to 9%)
Rent-setting mechanism	Budget basis (annual HUD review)	AAF
Percentage of residents who are elderly	Originally 15; now 25–30	Originally 45; now 55
Percentage Section 8 today	65	95
Type of Section 8	LMSA	AAF
Section 8 cost per apartment per year	About \$4,200	About \$8,000

the cream of the older assisted inventory, are expected to leave the assisted housing stock as owners exercise their prepayment right.

The properties that remain in the assisted stock will be, by definition, those for which prepayment is not economically feasible. Most have rents near local market levels; some have rents above local market. Generally speaking, rents in the likely remaining older assisted properties are 10 to 20 percent below HUD's estimated FMRs, but one subset—perhaps 15 percent of the apartments—is above market.

The protracted semiadversarial stalemate between owners, who are requesting rent increases, and HUD, which is scaling back assistance, has tended to deprive the properties of capital reinvestment funds. Consequently, the properties are deteriorating. According to a 1993 study by Abt Associates, as of that time 31 percent of all

FHA-insured older assisted properties were “distressed” and another 21 percent were “stressed” in terms of their physical needs and the internal resources available to address them (Wallace et al. 1993). Exterior work on roofs and siding has consisted of patching and painting rather than making replacements. Physical systems such as heating, ventilation, and air conditioning are outdated and will be expensive to replace. Appliances (especially microwave ovens, dishwashers, and garbage disposals) are aging or were never included in the property. Bathrooms are dated and often there are too few for the size of the apartment (one bathroom in a three-bedroom unit is common). Floors are tiled rather than carpeted. Insulation is usually below today’s standards, and most properties have been able to implement only the most inexpensive and immediately cost-effective energy conservation measures, such as low-flow aerators or toilets.

Given current limited internal resources, the properties face further deterioration as the history of inadequate maintenance and capital repairs continues. Replacement reserve balances are low, averaging \$300 to \$1,000 per apartment,¹¹ and annual deposits are meager, ranging from \$150 to \$250 per apartment per year. (By comparison, an economically competitive conventional apartment property will typically require between \$250 and \$600 per apartment for routine annual renovations, not including any deferred maintenance.) As a result, the more capable managers are often funding continuous replacement-and-upgrade programs through the operating budget. These camouflaged capital improvement programs are one reason why HUD properties seem to carry higher operating costs than comparable conventional properties.¹²

The properties do have some market and economic advantages. Apartment layouts, though dated, are generally spacious. Mortgages on the properties are very low, averaging \$10,000 to \$12,000 per apartment (Smith 1995). Most are located in established and slowly improving blue-collar neighborhoods. Although they may have a local reputation as a place where poorer families live, they are long-standing and well-integrated components of their communities, and most important, they provide much-needed affordable housing.

About 65 percent of the older assisted apartments now receive Section 8 LMSA. The original LMSA contracts, typically of five years’

¹¹ Statistics in this paragraph are the author’s estimates based on personal experience with roughly 750 HUD older assisted properties.

¹² Some family properties have also expanded social services to residents as needed.

duration, are still being renewed but on one-year terms that provide a minimal subsidy with an uncertain future.

Newer assisted inventory. As might be expected of properties enjoying rents that are well above market, the newer assisted properties present a very different physical appearance than their older counterparts. These properties tend to be well located; indeed, many are the best properties in the community. This is especially true of high-rise apartments for the elderly located in a rural area's county seat or family apartments in an economically disadvantaged inner-city neighborhood. Newer assisted properties tend to have ample cash flow and, in most cases, their physical condition is good to outstanding. On the other hand, some properties in the newer assisted stock have problems that are painfully evident, particularly to U.S. General Accounting Office (GAO) auditors and local media.

Fully half of the newer assisted stock is designated for elderly residents. These complexes are usually model communities.¹³ As residents grow older (the average age upon moving in is about 65; overall, residents' average age is 78),¹⁴ most properties for the elderly have added a variety of social services for the increasingly frail population. The cost of including these services is one reason why HUD properties tend to incur higher expenses than market-rate properties. All resident services are funded through rental income.

From a social perspective, the newer assisted properties are huge successes. But they are also costly. With current rents averaging 135 to 140 percent of FMR and current mortgages in the range of \$30,000 to \$35,000 per apartment, returning rents to local market levels would, in many cases, result in either default or a drastic and destructive cut in services or maintenance.

The original contracts on the newer assisted properties were for a 20-year term, beginning at completion of construction. Because most were developed from 1977 through 1981, contract expiration will peak in fiscal years 1998, 1999, and 2000.

In addition to these Section 8 AAF properties financed under NC/SR, in a late amendment Congress included the FHA-insured Section 8 Moderate Rehabilitation (Mod Rehab) AAF properties as well. About 125,000 apartments were developed under the Section 8

¹³ The introduction of "nonelderly disabled" (a category that includes recovering drug users) into previously all-elderly properties has created major management problems at some properties and is a continuing programmatic headache.

¹⁴ Statistics on residents' ages are not fully tracked by HUD, but this estimate is consistent with summaries provided by HUD from the TRACS (Tenant Rental Assistance Computer System) accounting of Section 8.

Mod Rehab program,¹⁵ typically with a single 15-year contract, between about 1985 and 1989. In 1989, revelations that political favoritism had influenced the awarding of contracts and allegations that rents had improperly been set too high caused the Mod Rehab program to collapse. Over the past several years HUD has embarked on an extensive legal effort to reduce Mod Rehab rents but with spotty success. As a result, these developments were eventually included in mark-to-market via Section 512(2)(B)(iii), although large-scale contract expirations are not expected for several years.

Properties exempt from mark-to-market. In addition to the housing developments already discussed, several categories of HUD multi-family assisted properties are not subject to the mark-to-market legislation:

1. *Section 202 and 515 properties.* The Section 202 program resulted in the development of about 5,500 properties for the elderly, totaling an estimated 275,000 apartments. The properties are owned by nonprofits and were predominantly¹⁶ financed with a direct HUD loan analogous to Section 221(d)(3) or Section 236. Section 515s were financed by the Farmers Home Administration (now known as the Rural Housing Service within the U.S. Department of Agriculture); some of them are now supported by property-based Section 8. Typically small, generally successful, politically sacrosanct, and with budget-based rents, Section 202 and 515 developments are exempted from MAHRA by Section 524(a)(2)(C).
2. *Properties that have Section 8 contracts coterminous with their mortgage.* Approximately 200,000 properties were developed using Section 8 AAF after the regulations were changed to create a dividend limitation. They typically have contracts that last as long as the remaining mortgage term (usually 40 years).¹⁷ Although their rents are just as far above market as the properties developed under the old Section 8 AAF regulations, the coterminous contract limits Congress's options.
3. *Section 8 AAF properties financed by state housing finance agencies (HFAs) without FHA insurance.* About 225,000 apartments, mostly built under the Section 8 AAF new regulations and having coterminous contracts, were built with financing

¹⁵ Some Mod Rehabs used uninsured HFA-financed or local bonds and are thus exempt from mark-to-market under Section 524(a)(2)(A).

¹⁶ In October 1991, HUD converted new Section 202 funding from loans to grants.

¹⁷ Some have a strict 40-year contract; others were structured as a series of 5-year contracts renewable at the owner's option. Needless to say, owners tend to renew.

from uninsured HFA tax-exempt bonds (typically from 1980 through 1983, when high interest rates made taxable financing economically unfeasible). Like the Section 202 properties, HFA-financed properties are politically popular and have been statutorily exempted from mark-to-market via MAHRA Section 524(a)(2)(A).¹⁸

Overall taxonomy. Although the older assisted inventory is eligible to participate in mark-to-market, most of the properties' rents are below market. In cases where the rents are above market, it is because HUD *approved* the budget-based rent increases that enabled rents to rise to those levels, so the likelihood that HUD will grant those properties a budget-based exception is high.

Thus, most observers expect mark-to-market activity to be concentrated among the newer assisted Section 8 AAF properties, of which about 75 percent have rents above local market levels. Over the next four to five years, an estimated 3,200 to 3,500 such properties (Smith 1995) will participate in mark-to-market restructuring.¹⁹

The origins of mark-to-market

As noted earlier, during the early 1990s the aging HUD portfolio and the looming bulge of Section 8 AAF' expirations were recognized as growing problems that generated increasing concern but no immediate action to roll back rents. The call to action came in November 1994, when the Republicans gained control of both houses of Congress for the first time in nearly 40 years.

The basic concept

The change from Democratic to Republican control of Congress in 1994 coincided with the impending flood of Section 8 contract expirations and intersected with more than a decade's consistent atrophy of HUD's mission and capacity. The Republican freshmen came to town determined to reorient government priorities.

¹⁸ Some HFA-financed properties also had FHA mortgage insurance, which would ordinarily subject them to mark-to-market, but the HFAs suggested that this would run contrary to their financing agreements (principally bond call protections). Whether this argument is valid or not, and regardless of how many properties it may affect, Congress incorporated, via Section 524(a)(2)(B), an exemption for HFA-financed, FHA-insured properties if mark-to-market would be "in conflict with applicable law or agreements governing such financing."

¹⁹ Changing rental market dynamics—strengthening markets in many areas—coupled with lower costs of capital for multifamily real estate may have significantly lowered these figures today.

Their attention was naturally drawn to HUD, a cabinet department that ran programs about which most of them were ignorant and served constituencies whose members had voted for their opponents.

Although GAO and the HUD inspector general both identified HUD-assisted properties with rents of 175 percent or more of local FMRs, the Republican reformers hesitated to act initially because of the potential financial consequences. In addition to being one of the fastest-growing cabinet departments in terms of budget authority, HUD is a vast banker and asset manager. It has \$42 billion in loan risk outstanding (through FHA insurance or HUD-held loans) and an annual contractual outflow of about \$20 billion through all forms of Section 8 (FHA Annual Reports 1995–1998).²⁰ Cuts in Section 8 would threaten to trigger massive defaults and multibillion-dollar claims against the FHA insurance fund.

For an individual property, reducing rents to local market levels would likely mean that the property would default on its debt service. If that happened, the lender would gain the right under the FHA mortgage insurance contract to assign (sell) the loan back to HUD at a price equal to 99 percent of the unpaid principal balance, thereby transferring to HUD the cost of writing down the debt.

In February 1995, the U.S. Department of Veterans Affairs/HUD Senate Appropriations Committee held its first hearing on mark-to-market. Though HUD was unable to estimate the likely costs of the legislation, outside analysts (Smith 1995) projected that if all expiring Section 8 contracts were marked to market (that is, if rents were reduced to local FMRs), the following would occur:

1. About 4,000 properties comprising 445,000 apartments would go into default. Approximately 93,000 of these apartments would be unable to pay any debt service and would risk being closed down.
2. The FHA insurance fund would have to pay about \$11.6 billion in net claims.
3. Recoveries on reconstituted first mortgages might be \$3.4 billion.
4. The net cost to the FHA insurance fund would be about \$8.2 billion.

²⁰ Section 8 and similar public housing authority assistance funds about 4 million households nationwide, broken down into three categories that are roughly equal in size: portable assistance (vouchers and certificates), public housing support, and HUD multifamily property-based assistance.

5. Annual outlay savings would be about \$1.0 billion, including \$750 million in reduced Section 8 plus recapture of about \$250 million in Section 236 interest reduction payments.

During the ensuing two and a half years of contentious debate, HUD conflated into the mark-to-market discussion a series of policy dogmas (such as “all properties must voucher” and “all loans must be sold for the highest achievable price”) that enabled the disorganized stakeholders to coalesce into a reasonably united group.

The result, MAHRA (see table 3 for an abbreviated legislative summary), embodied these broad principles:

1. The predominant objective is to *cut Section 8 discretionary outlay costs* by lowering rents to levels that are comparable with local market rents.
2. Consistent with the first objective, the act is intended to minimize net claims to the FHA insurance fund.
3. The legislation calls for a clear, orderly process in which stakeholders—especially owners and residents—could participate with some confidence.
4. Properties will be recapitalized to make them economically viable over the long term without continuing dependency on subsidy.
5. As a general rule, assistance under Section 8 is expected to continue to be property-based, although change to tenant-based assistance, or “vouchering out,” is possible under certain circumstances.
6. Wherever possible, existing perverse incentives will be eliminated, and unnecessary or excessive regulations will be peeled back. Performance mandates will be shifted from *process compliance* (Were the rules followed?) to *outcome compliance* (Were the desired results achieved?).
7. The workload will devolve from HUD to state and local PAEs that will have broad but precisely defined authority to act on HUD’s behalf in making decisions regarding the recapitalization of individual properties.

Almost all expiring contracts will be renewed for only one year, which will (1) increase the number of contracts expiring each year and the annual appropriations needed for renewals and (2) stabilize yearly budgetary requirements (which had been widely variable as

*Table 3. Multifamily Assisted Housing Reform and Affordability Act
Legislative Summary*

Structure of MAHRA

Eligible properties include the following:

Section 8 subsidy type

- NC/SR
- LMSA
- Mod Rehab
- Property disposition
- Conversions from rent supplement or §23

Mortgage status

- FHA insured
- HUD held (formerly insured, claim paid)

Uninsured mortgages (for example, those with state HFA financing) are generally excluded (and will be eligible for contract renewals at rent levels that avoid default).

Owners are ineligible if they have engaged in a pattern of adverse behavior, but the property can proceed through the process if the owner agrees to transfer the property (likely to a nonprofit).

Who does the restructuring? PAEs, which will generally be HFAs, although nonprofit and even some for-profit entities may conceivably be PAEs. Although it must accept stakeholder input, the PAE has principal responsibility for all relevant decisions, including mortgage resizing and assistance basing.

OMHAR oversight of PAEs. To select PAEs and ensure their performance, the legislation creates a new institution within HUD, the Office of Multifamily Housing Assistance Restructuring (OMHAR), whose director reports to the HUD secretary but is appointed by the president and has independent reporting authority to Congress.

Property and mortgage restructuring

Restructuring plans. Working with the owner (and the mortgage lender, if appropriate), the PAE will develop and negotiate a mortgage restructuring and rental assistance sufficiency plan (the “restructuring plan”) that will include the following:

1. General reduction of rents for all Section 8 apartments down to local market (or 90 percent of FMR if there are too few comparables) but no greater than 120 percent of FMR. (Up to 20 percent of the properties can have exception rents up to 120 percent of FMR, usually after elimination of all required debt service.)
2. Debt relief. First mortgages will be reduced to levels supportable by the new debt, with the balance funded via a new HUD “soft second” loan that accrues interest at a low rate (most probably 0 or 1 percent), matures when the first mortgage is fully repaid, and in the interim consumes 75 percent or more of the cash flow.
3. Assistance basing. Some properties are assured of ongoing property-based assistance:
 - Elderly, disabled, or special-needs residents
 - Properties in low-vacancy areas (to be defined)
 - Properties receiving exception rents on a budget basis (usually after eliminating all required debt service)
 - Nonprofit cooperatives

For all other properties, the PAE will decide whether renewed Section 8 assistance will be property based or resident based, using a long list of factual criteria and after considering resident and community views.

**Table 3. Multifamily Assisted Housing Reform and Affordability Act
Legislative Summary** (*continued*)

Property and mortgage restructuring (*continued*)

4. Rehabilitation as required to address long-term physical needs. The PAE may approve using federal funds for up to \$5,000 per apartment (if the owner matches with 25 percent of the assistance from nonproperty sources).
5. Ongoing affordability restriction for at least 30 years that will consist of (1) the owner's commitment to renew Section 8 if offered on terms equivalent to those in the restructuring and (2) some contingent affordability commitment (such as capping rents at Low-Income Housing Tax Credit (LIHTC) ceiling for some of the apartments) even if Section 8 is not renewed.

Restructuring tools. The PAE may use all of the following:

- Payment of claim on the current insured mortgage
- Refinancing, with or without FHA mortgage insurance or other forms of credit enhancement
- Existing property cash reserves, including replacement reserves and residual receipts. As an inducement to the owner, the PAE can offer 10 percent of these funds to the owner.
- Federal rehabilitation grants, not to exceed \$5,000 per apartment, with the owner contributing at least 25 percent of the total rehabilitation costs from nonproperty sources (which may include state or local resources such as HOME, Community Development Block Grants, or equity derived from LIHTCs).

Ongoing property monitoring. Generally speaking, properties restructured under MAHRA will have their regulatory and compliance monitoring responsibilities transferred away from HUD, probably to the PAEs, which will also typically act as the Section 8 contract administrators.

Timing

Programmatic implementation. MAHRA will become effective in time for the fiscal year (FY) 1999 expirations (starting October 1, 1998). In the meantime, the FY 1997 demonstration program will be extended to cover the remainder of FY 1998.

Property restructuring. During the negotiations around the restructuring plan, Section 8 contracts can be temporarily extended, but at the expected new rent levels. This will create a sense of urgency throughout the process.

a result of the five-year renewals offered to the first expiring Section 8 contracts in the early 1990s) (Campbell 1997).

How MAHRA will work in theory

As enacted into law, recapitalization under mark-to-market involves five sequential phases.

Phase I: Intake and policy decisions. Participating in mark-to-market is the owner's option—any owners who want to opt out are

free to do so (of course, they have to find ways to keep paying the debt service on their properties). Because participation by owners is voluntary, Congress and HUD can set whatever rules they choose.²¹

Mark-to-market is presumed to be a financial concession offered to owners by a benign government that intends to extend the benefits of debt relief only to good (that is, well-maintained and economically viable) properties run by good (responsible and compliant) owners. PAEs will need to make threshold policy decisions on issues such as the following:

1. *What should be done with bad (poorly maintained, structurally damaged, fatally flawed) properties?* Some properties will be uneconomic to salvage, in which case the residents should be given vouchers and the property should be foreclosed.
2. *Which owners should be disqualified?* Under Section 516(a) of MAHRA, owners of good properties can nevertheless be disqualified if they have materially abused the system, either on the subject property or through their pattern of conduct. This is a strong standard intended not only to avoid rewarding problem owners (by rescuing them from their problems) but also to motivate good behavior before contracts expire.
3. *Should assistance be based on the property or the resident?* In the legislative debate, all stakeholders except HUD strongly favored the continuation of property-based assistance, a view Congress ultimately embraced. Under MAHRA Section 515(c)(1), a safe harbor of property-based renewal is allowed for properties for elderly or disabled residents and for properties located in tight markets. Beyond that, the critical decision of assistance basing is left to the PAE, which must consider eight factors listed in Section 515(c)(2), including resident housing alternatives, local housing needs, cost of each option, and property viability.

Because these issues directly affect whether and how properties are underwritten financially, decisions regarding them must be made before the underwriting process begins.

²¹ By contrast, preservation programs such as the Emergency Low Income Housing Preservation Act (ELIHPA) and LIHPRHA were mandatory, in effect takings of the owners' right to convert their property to market use. Under the Fifth Amendment's takings clause ("nor shall private property be taken for public purpose without just compensation"), this compelled Congress to enact and HUD to implement a procedure that gave owners full value. That necessity made the preservation program turbid and frustrating for all concerned (and has led to a series of successful lawsuits against HUD by owner groups seeking recovery of compensation shortfalls arising from programmatic delays). It also provided strong impetus to make sure that mark-to-market would never expose the government to takings claims.

Phase II: Underwriting. After the threshold policy decisions have been made, the real work of underwriting the property on an economic basis begins. Underwriting is difficult for the following reasons:

1. The PAE must estimate new market rents. This is inherently difficult, the more so because the property will likely be undergoing a repositioning and upgrade.
2. The properties have operated for more than 20 years on an explicitly nonmarket basis. Reorienting them to market principles requires a top-to-bottom restructuring and, perhaps more important, a paradigm shift by owners, residents, and community.
3. The properties contain long-standing tenants with established expectations about services they now receive.
4. Some of the properties have a capital backlog that should be funded during the recapitalization and that will affect property operations after recapitalization.
5. The capital markets are not accustomed to underwriting properties such as these and will be hesitant to do so.
6. A huge volume of properties will need to be addressed quickly—an average of about 1,000 per year nationwide.
7. The underwriting will be done by PAEs, many of which will be unfamiliar with the properties and may not be well informed about HUD programs.

Underwriting these properties will involve answering a host of difficult technical questions. Because making a major mistake on any one of these questions, or just being unlucky in the new market operations, could put the property back into default, it is likely that both HUD's underwriting guidelines and the PAEs will take a conservative approach. The legislation's drafters recognized this fact and made sure that at least three-quarters of the future cash flow of participating properties would be returned to the government through the soft second mortgages to be created under MAHRA.

Mark-to-market underwriting is difficult and demands special skills. As shown in table 4, the issues it raises are so property specific that Congress elected to delegate most of the decisions to the PAEs. Because the PAEs are public entities, they are politically accountable, but the legislation does not address how to make them economically accountable.

**Table 4. Mark-to-Market Underwriting Sequence
Activities, Policy Questions, and Legislative Resolution**

Step	Activity	Policy Questions Raised	Legislative Answers
Step 1	Identify above-market properties	<ul style="list-style-type: none"> • Should below-market properties be restructured also, and if so, how? 	<ul style="list-style-type: none"> • No, leave as is, but when in doubt, allow intake
Step 2	Determine new market rents	<ul style="list-style-type: none"> • Formula or property specific? • Are properties allowed a transition? • Who does it? 	<ul style="list-style-type: none"> • Comparable where identifiable; 90% of FMR where not • Unspecified • PAE
Step 3	Satisfy old mortgagee <i>Absorb claim in FHA insurance fund</i>	<ul style="list-style-type: none"> • If default, full assignment, partial payment of claim, or a new hybrid? • What about uninsured mortgages (for example, state HFA)? 	<ul style="list-style-type: none"> • Partial payment of claim authorized <i>without</i> mortgagee consent • Uninsured properties exempted
Step 4	Determine new net operating income	<ul style="list-style-type: none"> • Section 8 property or tenant based? • Changes in operating budget? • Need for repairs or renovations? • Increased reserves? 	<ul style="list-style-type: none"> • Mostly property, but PAE can voucher • Expected; up to PAE • HUD grant with owner 25% match • Likely in underwriting
Step 5	Establish new debt service	<ul style="list-style-type: none"> • Protect owners' cash flow? • What level of coverage? • What happens to properties with zero cash flow? 	<ul style="list-style-type: none"> • No • Unspecified • Budget-based exception (likely with zero debt service)
Step 6	Price new mortgages	<ul style="list-style-type: none"> • New FHA insurance or not? • What happens to reduced debt? • Owners' tax consequences? 	<ul style="list-style-type: none"> • PAE within limits • Soft second mortgage • Unlegislated; legislation hopes for a favorable revenue ruling from Treasury
Step 7	Sell new mortgages <i>Recover on old FHA claims</i>	<ul style="list-style-type: none"> • Are properties held in HUD inventory? • Who sells the loans? 	<ul style="list-style-type: none"> • Unspecified • Unspecified

The act recognizes that underwriting is a financial transaction that seeks to maximize the lender's protection (and in this case, the government's recovery). Some properties will leave the assisted inventory; others will be consigned to default, foreclosure, and eventual disposition (presumably into the conventional marketplace) or demolition. For those that remain affordable, resident affordability and resident benefits will inevitably be affected, even if only at the margin.

Phase III: Exception benefits. Recognizing that individual properties have unique characteristics and may differ greatly from each other, Congress allowed HUD (and its agents, the PAEs) the flexibility to bestow benefits upon physically sound, well-run properties that effectively provide needed affordable housing. Chief among these benefits is the Section 514(g)(2) authority to provide "exception rents," defined as rents at levels that are needed to sustain the stock, on a budget basis, for well-run, performing properties that would be not be viable at local market rents.

In some areas, especially those with low rents and weak markets, demand for exception benefits could exceed availability.²² If so, pressure will fall on HUD to loosen the legislative constraints. But pressure will also be exerted on PAEs and other state or local entities to produce, from their apparently empty pockets, incremental resources to save those properties that the community values.

Phase IV: Approval and closing. For a property to participate in mark-to-market, the owner's consent will be required, but perhaps more important, so will the PAE's. The legislation requires the PAE to conclude, as HUD's agent, that the restructuring plan for a property is a wise use of federal resources, minimizes net cost to the FHA insurance fund, and protects the residents. HUD, through OMHAR, will review PAE decisions. The act does not specify whether HUD review is to be "retail" (in which case HUD would have a property-by-property veto) or "wholesale" (in which case HUD may not second-guess a PAE but can replace it with another entity).

Once the restructuring plan is approved, the recapitalization must be closed, which involves not only a transfer of funds as part of the debt restructuring but also recordation of the use agreement and delivery of the new Section 8 contract.

²² Some stakeholders, chiefly those in more rural states with a high proportion of all-elderly properties, loudly questioned the Section 514(g)(2) cap limiting exception rents to 20 percent of the properties within the jurisdiction of any one PAE, so in the final legislation, Congress added Section 514(g)(2)(B) allowing HUD to waive the 20 percent cap based on a finding of special need.

Phase V: Post-closing monitoring and compliance. Mark-to-market puts in place a new operating and affordability paradigm that is expected to last for 30 years, during which time HUD will be due contingent debt-service payments on the soft second mortgage and will have contingent enforcement remedies such as accelerating the soft second. HUD must designate an entity—perhaps the PAE, perhaps a contractor—to monitor policy compliance, administer Section 8 assistance, act as an asset manager for the program’s operations, and collect soft second-mortgage payments. That entity or HUD must also implement enforcement remedies when required.

Is mark-to-market a good idea? Mark-to-market was first proposed in an environment of apparently insurmountable budget deficits. Now the federal budget is in surplus. Given the changed national economic environment, is mark-to-market still needed?

Mark-to-market is enormously complex, with large up-front costs in pursuit of projected future paybacks that may not materialize. It will be implemented through irrevocable contracts, written so quickly that by the time procedural errors are discovered, they cannot be corrected. Are the likely benefits worth the risks? I believe they are. In terms of direct financial consequences over time, benefits will slightly exceed costs. But more important, mark-to-market represents a sound redirection of policy for the following reasons:

1. When a property’s rents are far above market and its debt is higher than the market will support, HUD and the property owner have few options beyond intermittent (and economically questionable) injections of more cash to prevent default. Because few owners will do this, HUD is at risk already, and mark-to-market provides an orderly mechanism that should minimize net costs. Adjusting rents down to market levels creates new options: to refinance the project, to withdraw or modify the subsidy, to restructure regulations or affordability, or to change participants. In a world of rapid financial change, having an array of options is valuable in itself.
2. Restoring economic equity (value that flows from property operations rather than through tax benefits) allows transfusions of new capital, which the inventory needs and will continue to need.
3. Real estate is inherently dynamic, yet the HUD portfolio has been static. Placing the inventory under constructive tension encourages new thinking, innovation, ownership transfers from the less to the more capable (whether nonprofit or for-profit), and a fresh look at a complacent inventory.

4. Restoring market orientation, even potentially at a financial cost, makes HUD Section 8 residents into consumers with greater options; this injects a healthy attentiveness in owners and managers. (At the same time, low-income residents must be protected from unwarranted displacement.)
5. Mark-to-market represents a dramatic reduction in the amount and complexity of HUD regulation that has characterized assisted housing programs in the past. Reducing HUD regulation through devolution of responsibility not only makes the program easier to implement and more understandable but also acknowledges and accommodates HUD's reduced administrative capacity.

Assuming that mark-to-market is implemented wisely, it will generate numerous benefits to various participants. However, if it is not implemented wisely, the results could be disastrous. Congress left unanswered in the legislation an extraordinary number of critical policy questions, deferring them to HUD (which may, in turn, defer some of them to the PAEs). How HUD implements mark-to-market will, to a great extent, define whether the program succeeds or fails and who wins or loses.

Moving from legislation to implementation

Even before MAHRA, Congress put a demonstration program in place for fiscal year 1997. Under this preliminary version of mark-to-market, owners could opt out or elect to participate in debt-restructuring negotiations, although owners who stayed with property-based assistance but declined restructuring were nevertheless eligible for one-year property-based renewals at 120 percent of FMR. The demonstration started slowly, in part because the procedures were new, in part because they were unpleasant, and in part because no one knew what the permanent law would look like.

Recognizing the complexity and infrastructure demands of mark-to-market, Congress sensibly extended the demonstration program through the end of fiscal year (FY) 1998 (September 30, 1998), effectively allowing HUD a full year to design and promulgate regulations and to qualify and put in place capable PAEs. Given all the challenges involved, a year is a short time.

Issues resolved

In enacting the legislation, Congress resolved many of the fundamental *portfolio policy* questions:

1. Mark-to-market *lowers* rents to market levels; it does not raise them.²³
2. Mark-to-market saves the good properties and their owners. Until decisions are made on individual properties, it consigns the remainder of the portfolio to an undefined and uncertain future.
3. Mark-to-market retains property-based assistance as the means of achieving affordability unless there are good reasons to change.
4. Mark-to-market puts in place a network of state and local PAEs that know their local markets and properties and are publicly accountable.
5. Mark-to-market is *not* a transfer program. However, if transfer occurs, voluntarily or involuntarily, a strong predisposition exists in the law to deliver these properties to nonprofit entities.

Outstanding issues

Among the important issues Congress left for HUD to determine in writing regulations to implement the legislation are the criteria for selecting and qualifying PAEs and decisions regarding assistance basing (property or voucher), originating new loans (FHA insured or not), and how the operating cost adjustment factor (OCAF) will be implemented to determine future rent increases. Each of these decisions affects the others, and all will affect overall mark-to-market dynamics. The key issues are described in more detail as follows:

1. *Assistance basing.* Determination of the type of assistance provided is a cornerstone of any subsequent underwriting. It has implications for the feasibility, timing, and amount of renovation; rent levels; resident protections; and community acceptance. What procedures, if any, will HUD prescribe for deciding whether a property will be eligible for Section 8 property-based assistance?

²³ Whether the legislation in fact precludes raising property-based rents became a small but significant interpretive debate. Section 524(a)(1) of MAHRA provides that “[T]he Secretary *may*”—not “shall”—“. . . provide assistance under Section 8 . . . at rent levels that do not exceed comparable market rents for the market area” (emphasis added). Some advocates argued that this language allowed HUD to go up to market in many situations that do not require debt restructuring, but HUD concluded that these renewals could only be at or lower than current rents.

2. *Resizing first mortgages.* Resizing first mortgages through completely new underwriting will affect decisions on assistance basing, the property's operations, feasible levels of renovation or rehabilitation, and the long-term economic viability of the property. Higher writedowns on first mortgages will make the portfolio safer; they will cost more in FHA insurance claims, but in compensation, the resulting soft second mortgages should be more valuable.²⁴ Detailed instructions may tie the PAEs' hands, yet loose guidelines invite potential abuse or at least the later appearance of abuse. What constraints (if any) will HUD put on PAEs regarding the resizing of first-mortgage loans?
3. *Postrecapitalization rents and the OCAF.* After a property is recapitalized under MAHRA, the level of property-based Section 8 assistance will be periodically increased by an OCAF. This may be applied to the entire rent, allowing the net operating income (NOI) to rise over time, or it may be applied only to the operating expenses, in which case the NOI and the property's cash flow will be flat. A middle-ground compromise OCAF would allow NOI to rise slowly but not as fast as inflation. Implementing OCAF conservatively could deprive the portfolio of future working capital, which would not only reduce the value to HUD of the soft seconds that will be created (and risk failure on the tax issues) but also imperil later operations. How will HUD implement OCAF?
4. *Qualifying PAEs and monitoring their performance.* PAEs will need expertise in HUD programs, the mark-to-market legislation, policy evaluation, and capital needs assessment. They must have the financial proficiency necessary to make sound (though not ultraconservative) decisions regarding underwriting of multifamily properties and the sale of restructured mortgages. The PAEs must also be properly motivated to balance MAHRA's complicated objectives and not simply treat the FHA insurance fund as a free resource. HUD advocated aggressively for the discretion to choose PAEs other than HFAs. By what criteria will HUD establish, qualify, and monitor PAEs? Will the review of PAEs by OMHAR be wholesale or retail in nature?
5. *Audit proofing.* The system for implementing MAHRA must be considered fair and workable by all interested parties, whether they will likely gain or lose from decisions that result. Yet given the complex and difficult decisions that will be involved with

²⁴ Section 517(a)(3) requires the soft second mortgage to be payable from "at least" 75 percent of future cash flow.

each property and the imperative for fast, high-quantity throughput, some misjudgments in underwriting are inevitable. Harsh or frequent penalties for errors will stall the process and strangle the program. The implementation process must balance the need to minimize errors yet encourage a certain amount of risk taking.²⁵ Given these concerns, how will HUD structure a system that will be reasonably defensible during audits performed by GAO or HUD's Office of the Inspector General?

Conditions for success

Three major preconditions *must* be in place for the program to function:

1. *The program must attract and motivate PAEs.* Restructuring mark-to-market loans will be a thankless business that involves shrinking resources, lowering stakeholder expectations, and adjudicating thorny policy and economic issues. To attract the number and quality of PAEs necessary for the program to succeed, PAE agreements must be workable, and PAE compensation must be sufficient. At the same time, HUD must protect the public trust by ensuring that PAEs are held accountable.
2. *It must provide safe-harbor tax deferral.* Forgiveness of indebtedness is a gain for the owner, so a debt write-off is little different from a foreclosure. Owners will need credible written evidence that the combination of reduced first and new soft second mortgage will be respected as such and prevent immediate recognition of gain. Section 7872 of the internal revenue code offers an exemption that protects below-market government loans (such as mark-to-market soft seconds) from restatement under the original issue discount rules. When crafting MAHRA, Congress concluded that it could not change the tax code but relied on Section 7872 to provide the solution.
3. *It must enable creation and sale of new reconstituted first mortgages.* When an FHA-insured mortgage defaults, HUD must pay the claim, and the loan becomes held by HUD. Although the new soft second can be held by HUD, the new first will need

²⁵ An excellent monograph listing audit-related risks in mark-to-market and discussing alternate means of addressing them is available from Charles S. Wilkins, The Compass Group, (703) 610-1357.

to be sold for cash,²⁶ which in turn requires someone to buy it—preferably at par. For this to happen, either the loan must carry new (or redirected) FHA insurance, or it must carry a market rate and terms. And because mark-to-market is a wholly new phenomenon, most financial advisors believe that HUD would have to offer higher coverage ratios (130 percent or higher) with concomitant reductions in federal recovery. Until many mortgages are restructured, they will be hard to sell, but unless they can be sold, they will be impossible to restructure. To resolve this conundrum, HUD could successfully implement the mandatory partial payment of claim (PPC) contemplated in Section 517(b)(1) of MAHRA, which states flatly, “Any payment under [PPC] shall not require the approval of a mortgagee.” Because mortgagees have rights, too, the PPC procedures would need to be modified to compensate their economic interest with a combination of payment at par (waiving the 1 percent discount) and an interest rate reset to market.

During 1998, substantial efforts were made on all these fronts, and all these critical problems appear now to be in place:

1. Between the FY 1997 and 1998 demonstrations and the interim regulation, HUD has attracted PAEs, with more than 39 HFAs qualified.
2. The viability of mark-to-market soft seconds was confirmed in July 1998 when the Internal Revenue Service (IRS) issued Revenue Ruling 98–34.²⁷
3. With HFAs embracing mark-to-market, prospects for viable new first-mortgage loan originations look good, although a reliable national product has yet to be developed.

Characteristics of successful implementation

Unlike programs designed to stimulate production of new housing, in which success is measured by total volume, in mark-to-market

²⁶ Theoretically, HUD could hold the new reconstituted first mortgages in its inventory until they season. Although this is what most lenders would do, the loan volume is about \$4 billion, and HUD has lost money holding defaulted loans such as Section 221(d)(4) unassisted properties, to the point where it embarked on a massive program of bulk loan sales. No one expects reconstituted mark-to-market first mortgages to remain held by HUD.

²⁷ The ruling responded to a request submitted by the accounting firm of Reznick, Fedder & Silverman, prepared in conjunction with several policy advocates including the author.

the potential volume is limited, and success is measured by the successful recapitalization of each property. At the same time, success means losing from the existing stock as few properties, owners, residents, and dollars as possible. For mark-to-market to succeed, its implementation must be characterized by the following:

1. *Stakeholder confidence.* Even if not enthusiastic, owners, residents, and PAEs must at least be willing to participate and be open-minded. For that to occur, they must view the process as fair and accommodating to their concerns.
2. *Clear rules.* If mark-to-market is to process 1,000 properties a year,²⁸ the process for resolving issues must be specific, deterministic, decisive, and expeditious. There should be no procedural surprises.
3. *Consistent outcome-oriented policy adjudication.* Operating within a flexible policy framework, PAEs must make consistent policy determinations when presented with the same facts. This is especially important because a number of sponsor groups will be processing multiple properties with multiple PAEs. HUD will thus have to provide clear guidance on critical policy issues, and where these apply at the sponsor level (for example, adjudication as a disqualified owner), it will need some means of rapid internal communication (for example, via HUD's Web site) to ensure that knowledge is disseminated consistently and widely.
4. *Smooth linear processing.* Activities and decisions in the process should be designed to move forward steadily and in a logical manner. To avoid delays and uncertainty, threshold issues, such as eligibility, or determinations on critical issues, such as local market rent levels, should be decided once and not revisited.
5. *Reasonable pace.* The recapitalization process for each property—and for all properties—must proceed quickly. If the process stalls, property owners may be compelled to reprocess because previous work is out of date and no longer valid. (This was a principal weakness of the LIHPRHA preservation program, where the typical throughput took more than two years.)
6. *Properties that are viable over the long term.* The true test of mark-to-market for a property will come not at loan closing but over time as the property ages. Although ongoing affordability

²⁸ This figure is based on there being 4,500 properties whose contracts are up between FY 1998 and FY 2002.

is a major goal, long-term physical and economic viability is a necessity because if the property fails, everyone loses.

These attributes are the criteria by which the management and implementation system that HUD devises should be judged. Without them, the program will not succeed.

Alternative approaches to implementation: Three thought experiments

The many required policy decisions could be made independently of one another, but a better approach is to design an overall schema of decisions that work well together to create coherent results.

To illustrate the issues, I present three distinct scenarios as thought experiments. Although they are not mutually exclusive, each would be an internally coherent approach to implementing the legislation. Each has distinctive features, some of which will clearly work better than others, others of which may be viewed as good or bad depending on one's policy orientation. Each is based on different preconditions, and each carries its own implications. Two of them work well; one is more problematic. But all have at least some chance of working.

1. Mortgagee-driven fast throughput using modified PPC

Overall concept. In this approach, PAEs would form teams with current FHA mortgagees as explicitly encouraged under Section 513(b)(3) of MAHRA.²⁹ The PAE would effectively subcontract underwriting and due diligence functions to the mortgagee while reserving policy decisions for itself. Mortgagees would presumably be compensated on a fee-for-service basis.³⁰

Under this scenario, HUD would streamline policy decisions by specifying in the regulations what protocols must be used for decisions on such issues as assistance basing, coverage ratios, and soft second-mortgage terms. Implementation streamlining would be ac-

²⁹ Section 513(b)(3): "For the purposes of any PAE applying under this subsection, PAEs are encouraged to develop partnerships with each other and with nonprofit organizations, if such partnerships will further the PAE's ability to meet the purposes of this Act."

³⁰ Equity participation by private entities is prohibited by Section 513(b)(7)(B) of MAHRA.

completed by making mandatory PPCs containing economic hold-harmless provisions to compensate mortgagee lenders. Using the PPC would keep a stub first mortgage in place, eliminating the need to sell it in the open marketplace and thus furthering fax executions.

Advantages and features. Every FHA-insured loan involves a lender, and every mortgagee lender has a loan servicer. Through the mortgagor's periodic reporting requirements, these loan servicers maintain current information on the property (and potentially others in its vicinity).³¹ They have extensive experience with HUD multifamily programs and make their livings structuring and sizing new loans. Thus, they are well positioned to evaluate properties, underwrite their operations, and resize their loans.

Mortgagees would also be the most logical (and probably the most efficient) implementers of mandatory modified PPCs, and they might also be the least expensive because they could anticipate a high volume of work. For this approach to succeed, however, mortgagees would have to be made whole, which might be difficult or might require some creativity in structuring the debt placement.

Disadvantages and risks. In mark-to-market processing, policy and economics take turns coming to the fore, which means there will be many internal handoffs between the PAE and the subcontracting mortgagee. Fee-for-service mortgagees may not have long-term accountability for their recommendations involving federal resources (for example, FHA insurance, rehabilitation grants), and if the PAE adopts rigorous per property oversight of the mortgagee analyses, much of the perceived processing economy will be buried in the internal information traffic. Servicers, who have fiduciary duties to their investing lenders, will also face conflicts of interest in resizing loans and may be uncomfortable pressing modified mandatory PPC in the face of likely mortgagee opposition.

2. HFA-financed first mortgages with a wholesale OMHAR review

Overall concept. Under this approach, state HFAs, with their lending experience and creditworthiness, would be the PAEs. HFAs would issue taxable bond pools, perhaps backed with partial FHA credit enhancement of some new variety, to originate new unin-

³¹ Because FHA loan servicing benefits from huge economies of scale tied to electronic data processing, the business is now concentrated in a handful of firms that together handle about 75 percent of all mark-to-market eligible loans.

sured first mortgages.³² If necessary, the HFAs could supplement their technical competence with private sector expertise. The HFAs would be compensated principally from direct or indirect participation in federal mortgage recoveries compared with a baseline projection.³³

A variation of this approach would allow HFAs to access FHA mortgage insurance via the current risk-sharing program, perhaps with an implied debit for the new credit subsidy involved. A second variation would use uninsured new financing but with nonprofit joint ventures restructuring loans on HUD's behalf in a model analogous to the FY 1998 demonstration program. This is explored further in the following section.

Advantages and features. HFAs are publicly accountable entities that balance finance and policy considerations. They already implement federal programs such as HOME, Community Development Block Grants (CDBGs), and Low-Income Housing Tax Credits (LIHTCs) and thus have developed allocation plans and scoring systems for targeting resources to priority needs. HFAs have access to the capital markets and an implied moral commitment to support troubled properties. Making HFAs the PAEs also would give them more of a stake in leveraging other, nonfederal resources to address the problems of distressed properties.

In addition, an incentive-oriented compensation system will encourage economic resolutions beneficial to the federal Treasury.

Disadvantages and risks. Incentive-oriented compensation to HFAs will also discourage them from attempting to restructure the more difficult properties. Because HFAs also act as asset managers for their own properties, they may have a conflict of interest regarding allocation of resources, which might subconsciously bias their decision making.

³² Taxable bonds are not the only possible execution for HFAs; they could also use the FHA risk-sharing program already in place at many HFAs. The HFA execution could also be used with full FHA mortgage insurance, although HUD would want protection in the form of strong financial motivations for the HFAs to ensure good downstream loan performance.

³³ MAHRA discourages but does not explicitly preclude equity participation for public PAEs, because the Section 513(b)(7) prohibition applies only to *private* entities. Even if equity participation per se were ruled incompatible with MAHRA, similar results could be achieved by incentive compensation systems that reimbursed direct out-of-pocket costs only and provided profit through fees that were a percentage of HUD's recovery.

HFAs that are accustomed to property-based assistance and are unfamiliar with HUD properties may seek high debt-service coverage ratios, funded reserves, and other protections that may limit HUD's recovery efforts. Although HFAs strongly support positive performance incentives, they would be reluctant to undertake restructuring unless they were assured a base level of profit and minimal downside. And because mark-to-market probably needs HFAs more than the HFAs need mark-to-market, HUD would likely need to provide these assurances.

3. Rigorous in-or-out screening to encourage owners to transfer properties or opt out of the program

Overall concept. Under this model, the PAEs (most likely public entities such as HFAs) would increase pressure on owners to convert properties to tenant-based assistance (that is, voucher out) or to transfer ownership to nonprofits. This could be accomplished overtly or covertly based on the rigor of screening protocols such as owner disqualification, criteria for assistance basing, requirements for owner contributions for property rehabilitation, and postrecapitalization OCAF and use agreements.

When owners decide to transfer either the property or their ownership interests, PAEs would provide technical assistance and capacity building to enable nonprofits to be capable buyers and owners. For good properties, and especially when the transfer is occurring because the owner has been disqualified for previous misbehavior, PAEs might also offer nonprofit organizations access to special resources such as HOME, CDBGs, LIHTCs, or real estate tax abatement or exemption that could make the properties economically viable.

Advantages and features. Encouraging owners to transfer to nonprofits or opt out was an explicit feature of the LIHPRHA preservation program, especially in its latter stages where funding limits were being overwhelmed by a late rush of demand. It was predicated on the twin premises that (1) many properties were in danger of being lost to the low-income housing inventory and (2) nonprofit entities are the best long-run custodians of affordability because they have as a mission the preservation of low-income housing. As with LIHPRHA, through the mark-to-market program the federal government is offering financial concessions to owners who elect to preserve their property via a 30-year use agreement, and the government could legitimately require owners receiving the financial concession to make a further policy commitment, such as substituting a nonprofit entity as controlling general partner.

Some mark-to-market resources, such as budget-based exception rents, are by definition scarce. If a scarce resource is being allocated, it could be directed based on considerations that are secondary to the legislation's primary purpose—in this case, by limiting budget-based rents to properties that have a nonprofit organization as co-general partner.

Disadvantages and risks. Congress considered the idea of stimulating transfers in mark-to-market and explicitly rejected it, so the HUD regulations should not bias the process toward property transfers. The legislation merely provides that if an owner transfers (either because the owner is disqualified or through owner initiative), then a nonprofit is the preferred buyer. HUD regulations with a nonprofit bias beyond that contemplated in the legislation might face a legal challenge.

Even within the permissible nonprofit advantages, pressuring owners coming into mark-to-market may induce undecided owners to transfer, but it will also create stress on residents and properties. That same pressure could also backfire, causing some owners who would ordinarily have stayed in the program to exit based on the decision to endure some pain now rather than be driven out halfway through the restructuring protocol. It would also motivate owners to avoid coming into mark-to-market, either by staying out of default (presumably through deferred maintenance) or by electing default without mark-to-market participation. Either result would seriously impact the portfolio, probably adversely, so that even if these owners later lost their properties, the cost to the federal government could be much higher.

The capacity of nonprofits is also an issue. In the LIHPRHA preservation program, about 200 properties changed hands over a three- to four-year period, and even this much smaller volume completely consumed the nonprofit community's capacity. Although the preservation program's sales did expand the capacity and expertise of nonprofits, mark-to-market will impose much greater demands—its universe of properties is four to five times larger, and the time frames for action are much shorter.

Transfers to nonprofits will make the program more costly for intermediaries. It may also expand the scope and cost of rehabilitation activities, as occurred during the waning days of the LIHPRHA preservation program, in which, to facilitate sales to nonprofits, standards for rehabilitation were broadened from the goal of returning properties to "good condition" to include more general—and typically, more expensive—improvements in housing quality, durability, and livability (GAO 1997).

Perhaps most fundamentally, the mark-to-market program was intended to be acceptable to all stakeholders, of whom owners are the largest and perhaps the most important constituency. A program that explicitly sought to dispossess them of their properties simply because of a change in policy orientation would face widespread opposition and might be a political failure before it ever got under way.

Roles for nonprofits

Over the past decade, when the HUD affordable housing debate has focused predominantly on preservation rather than new development, policy makers have explicitly favored direct nonprofit ownership. This is not surprising, because experience has proved that working with for-profit developers can be expensive. Although they offer the financial benefits of deep-pocket accountability, some for-profits participating in HUD programs have been criticized for equity takeouts, high management fees, and alleged equity skimming.

Nonprofit organizations have become more involved in ownership of federally assisted and insured apartments in recent years. Their involvement adds legitimacy to the transaction, involves tenants in making decisions about their homes, and is part of a broader community development mission that enables them to access funds for related services and activities (Bodaken 1997).

Despite its preference for working with nonprofits, Congress rejected making mark-to-market an ownership transfer vehicle, instead concentrating (rightly) on recapitalizing properties with a capable ownership entity, whether that is the incumbent for-profit owner or otherwise. Nevertheless, throughout MAHRA, nonprofit and resident organizations are accorded special standing, usually as policy advisors, and under Section 514(f)(3), up to \$10 million will be set aside for capacity building and technical assistance.

Nonprofit organizations can play four possible roles in the mark-to-market program:

1. Buyers

MAHRA contains provisions for the eventuality that some properties will be transferred to nonprofits voluntarily, either because current owners may be reluctant to reenlist with HUD or (more likely) because they are disqualified under Section 516(a) of MAHRA.

When a transfer is occasioned by owner disqualification, Congress directed HUD under Section 516(e) to “facilitate the voluntary sale or transfer . . . with a *preference* for tenant organizations and tenant-endorsed community-based non-profit and public agency purchasers [emphasis added].”

Because selling the property would trigger tax obligations with no means to pay them, actual real estate transfers will be uncommon. Virtually the same result can be achieved much less painfully by a transfer of controlling general-partner interest from the current sponsor group to a nonprofit. Because most disqualifications under Section 516(a)(2) will arise because of activities of the property owner's controlling general partner, withdrawal of the disqualified general partner would in effect change the owner under Section 516(a), and the property would no longer be disqualified for MAHRA processing.³⁴

Buying properties is exciting for nonprofits but, as the LIHPRHA preservation experience showed, it is also challenging and difficult. To buy properties successfully, nonprofits will need to do the following:

- Identify likely sales candidates. This may not be easy. Unlike LIHPRHA, where sale was voluntary and owners were required to indicate their attitude toward sale at the inception of the process, under MAHRA owners may be forced to sell because of disqualification, which may occur some time after the process begins.
- Contact property owners and open negotiations to buy the property.
- Secure rehabilitation funding and the negotiated purchase price from nonfederal resources. (Nothing in the statute explicitly exempts nonprofits from burdens of ownership such as the 25 percent rehabilitation matching contribution.)³⁵
- Process the purchase.
- Manage the renovations and operate the property.

³⁴ Converting a disqualified general partner into a special limited partner with no voting rights would also appear to satisfy Section 516(a), although this issue needs to be further specified in the regulations. And however HUD adjudicates the matter, it will have to be vigilant in policing extrapartnership arrangements that might lead to a disguised affiliate of the disqualified owner coming forward in the guise of a new nonprofit to subvert the statutory purpose. Nonprofits coming into an existing partnership as new general partners will also have to be vigilant that they are not being used as puppets or camouflage so that they have genuine involvement and control—but with that involvement or control will also come fiduciary duty to the investor's limited partners (which might include the very general partner whose misbehavior disqualified the property in the first place).

³⁵ Indeed, Section 517(b)(7) of the statute requires “each owner or purchaser” to contribute and allows an exception only for nonprofit housing cooperatives, not general nonprofits.

Nonprofits that wish to buy properties will need to understand the dynamics of aging tax shelter partnerships (Rumpf and Breidenbach 1997). They will also need technical assistance, and possibly additional financial strength, for which they may seek out capital partners.

2. PAEs

Throughout the legislative debate, one of the most contentious topics was who could be a PAE. HUD strongly favored having the authority to select for-profit entities with strong economic motivations as PAEs to minimize claims on the FHA insurance fund, citing as a model the joint venture partnerships created by the Resolution Trust Corporation (RTC) to dispose of the real estate assets of S&Ls. All other stakeholders strongly rejected the idea that purely profit-oriented entities could be vested with the public trust and public resources. The resulting compromise, expressed at length in Section 513(b), gave state HFAs a “reasonable” exclusive period and mandated HUD approval if the HFA were “qualified,” a term the statute left undefined.

Since enactment, HUD has continued to advocate for alternative PAEs in addition to the state HFAs, partly because HUD believes that state HFAs cannot manage all the eligible properties in the country. Some lack the capacity to underwrite multifamily properties. In addition, HUD would like HFAs to compete for this important role. In that spirit, HUD has established several joint venture pools, using a modification of the RTC model. The joint ventures are organized as follows: HUD has invited designated nonprofit entities to become restructuring agents by *buying* a 10 percent general partnership interest (with HUD as the 90 percent limited partner) in a pool of HUD mortgages of properties whose owners have voluntarily elected to participate in the FY 1998 demonstration.³⁶

HUD has recognized that nonprofits may take on the mantle of responsibility in fulfillment of their mission but that they will need both underwriting capability and financial wherewithal, so both the FY 1998 demonstration and MAHRA acknowledge the utility of partnerships between public and private sectors. Although for-profit entities could conceivably be the lead partner in such an

³⁶ In early 1998, a team headed by the National Association of Housing Partnerships and with Recapitalization Advisors acting collectively as a principal subcontractor handling due diligence and underwriting functions, won HUD's second FY 1998 pool involving 23 properties totaling about 1,900 apartments and \$40 million in unpaid principal balance on their HUD loans.

entity,³⁷ MAHRA is plainly more comfortable with a model in which the nonprofit is in control and the for-profit is a minority partner or a dominant subcontractor.

Pairing a nonprofit and a for-profit so that each has a financial upside and financial downside is quite shrewd: It neatly telescopes into a single restructuring entity the tensions that can result from having both economic and social goals. Forcing the for-profit and nonprofit to reach an understanding between themselves reflects the political and economic conundrum embodied in MAHRA.

3. PAE advisors

Nonprofits that wish to protect residents and communities but quail at the economic and political responsibilities and risks of actually being the PAE can assume the role of policy advisor. Under Section 513(b)(3), PAEs are encouraged to develop partnerships “with each other and with non-profit organizations.” In such cases, the PAE would presumably (but not exclusively) be the state HFA.

The role of advisor may be particularly suitable where the state HFA has limited experience with HUD multifamily underwriting, and a capable local nonprofit umbrella organization, such as a metropolitan or regional housing partnership, has been providing technical assistance or developing housing using the LIHTC program. Facilitating these pairings might also be a natural role for the National Association of Housing Partnerships, whose 44 members are located throughout the country.

4. Resident capacity resources

The framers of MAHRA also recognized that residents are the principal beneficiaries not only of the original housing assistance programs but also of recapitalizations under MAHRA. As such, they may need representation and technical assistance. Section 514(f)(2) of MAHRA requires that residents participate in the assistance-basing decision, the restructuring plan, and any proposed transfer. To help ensure that their participation is meaningful, Congress authorized up to \$10 million in technical assistance for tenant groups, nonprofit organizations, and public entities.

Many nonprofits will likely assist in building residents' capacity and provide technical assistance to tenant groups. Judging from the interest shown by nonprofit and resident capacity groups so far, demands on this money will be heavy.

³⁷ Section 517(b)(7)(A) allows for-profit PAEs but requires them to enter into partnerships with public-purpose entities (including HUD); hence, this model also encompasses the FY 1998 demonstration structure.

HUD's implementation process: Ready to go on time

Right after MAHRA was enacted, HUD decided to fast-track the regulation writing. Unlike new production programs, where activity picks up slowly once the regulations are published, in mark-to-market the program's rules, regulators, and participants must be ready for action at the outset. This meant putting in place not just the rules but the PAEs to implement them and then motivating owners to participate constructively.

To compress an 18-month process down to little more than 6 months while still complying with the rule-making procedures, HUD invited opinions from a wide range of stakeholders through concept papers and focus groups. Both approaches attracted numerous participants. Although many of the positions taken might be considered predictable, through this process HUD identified the stakeholders' key issues and concerns quickly and effectively, received a healthy smattering of creative ideas, and tacitly market-tested possible solutions.

With a little help from its friends, HUD remarkably accomplished everything on time:

1. As noted earlier, in July 1998, acting at HUD's request, the IRS issued Revenue Ruling 98-34 approving soft second loans (subject to appropriate fact-specific tests) as valid debt and thus addressing the owners' tax problem.³⁸
2. In late August, HUD published its *Request for Qualifications* for PAEs, incorporating a 100-point scale designed to motivate HFAs and others to strengthen their capacity by forming teams that include capable specialists in FHA underwriting, multi-family workouts, and resident relations.
3. On September 11, 1998, HUD published the interim regulation in the *Federal Register*.
4. During October, President Clinton nominated and the Senate confirmed Ira Peppercorn, former executive director of the Indiana Housing Finance Agency, to be OMHAR's director.
5. In late October, HUD approved more than 30 HFAs as PAEs covering most of the country and qualified roughly a dozen non-public PAEs (mostly nonprofits or nonprofit partnerships) to handle the remaining properties.

Putting the delivery system in place on time was a great accomplishment. Even if the system needs later tweaking in light of expe-

³⁸ The soft second mortgage must have characteristics of debt, not disguised equity, and it must be "in the money"—reasonably expected to be paid off. Most mark-to-market properties will satisfy these tests.

rience, having a working delivery system with functioning PAEs and optimistic participating owners will likely give mark-to-market the institutional momentum to succeed.

HUD's implementation decisions: The interim regulations

In its regulations, how did HUD reconcile the competing interests? Generally speaking, HUD's implementation steers a solid middle course in favor of smooth and rapid processing, rejecting both the quick mortgagee route and attempts to induce sales to nonprofits. Although the regulation allows for PPC, HUD largely spurned this alternative (Section 401.460). In emphasizing HFAs as PAEs (Section 401.201), HUD also fully embraced the statutory predisposition in favor of HFA financing, although its stronger qualification requirements for HFA PAEs (Section 401.201[c]) had the salutary effect of stimulating HFAs to supplement their capacity before designation.

The regulation emphasizes real underwriting to high standards. Rents are to be set at market levels (Section 401.410), with the 90 percent-of-FMR proxy rent used only as a last resort. Most properties will continue with property-based assistance (Section 401.420). Postrecapitalization rents will rise (Section 401.412) using a thin OCAF that will allow cash flow to rise but only slowly, placing an initial premium on careful underwriting. Residents will be able to comment twice, once at the beginning and once at the end of the restructuring process (Section 401.500), which will allow properties to move through the process. HUD will approve recapitalizations one by one (Section 401.405), at least until the administrative handbook is issued.

The regulation ducks a few issues:

1. How the new debt will be sold, and whether FHA mortgage insurance will be used, is left largely opaque (Section 401.460[e]), although the regulation allows PAEs to set interest rates and coverage ratios to allow a par execution (Section 401.460[c]).
2. Should a property be vouchered out if the owner decides to go market, the regulation (Section 402.9) does not specify whether the new voucher is regular (capped at FMR) or enhanced (set at true market levels for the subject property).
3. If a property or owner is rejected, the regulation allows an appeal (Section 401.645) but does not address what happens if the property is finally disqualified. Because no good answers have been provided for such cases, the regulation's silence may prove wise.

In truth, the regulation illuminates the statute only in limited ways. Many further crucial program details, such as the precise terms of soft second mortgages (Section 401.461) or the mechanisms by which PAEs will decide whether to disqualify an owner (Section

401.101), are largely deferred to HUD's administrative guidance. Although this may be frustrating for program participants, who must wait for yet another HUD publication to understand the program properly, it allows HUD to be flexible and dynamic in changing program parameters as conditions change. This will be a good thing so long as the administrative handbook continues the philosophy, expressed in the regulations, of concentrating on financial restructuring and not loading down the process with secondary agendas.

Thus, in its interim regulation, HUD declined the chance to spin the statute and instead concentrated on getting a system in place that can work for a large number of properties. Though incomplete and inevitably unsatisfactory in some respects, it is a calm and measured regulation that will enable the program to get going effectively. Considering the difficulties HUD has faced, this is an excellent start.

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