

## Tax and Direct Expenditures: Perspectives On Prepayment Proposals

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### *Abstract*

If the government were committed to replenishing the inventory of project-based assisted housing units when losses occurred, owners' prepayment rights, with prepayment penalties, would be a desirable feature of the program. Additional unsubsidized housing units would be created every time a prepayment occurred, the freed-up subsidies and insurance commitments would support a replacement low-income unit, and prepayment penalty income could be used to offset mortgage insurance losses and thereby reduce the cost of mortgage insurance.

Under the much less than ideal conditions now prevailing, with no replacement project-based housing available and no buy out arrangements in place, federal policy must attempt to limit prepayment by the owners of subsidized projects over the next few years.

An approach to establishing a "maximum price" that the government should be prepared to pay to induce each prepayment-eligible building owner not to prepay is presented.

The Housing and Urban-Rural Recovery Act of 1983, which terminated authorization of the Section 8 New Construction and Substantial Rehabilitation programs, effectively set a ceiling on the number of privately owned housing units that would be contractually reserved for non-elderly, non-handicapped, low-income households. Thereafter, the number of such units could only decline.

Until the last few years, reductions in the privately owned assisted inventory were all involuntary. A number of buildings receiving different kinds of project-based assistance and, in most cases, Federal Housing Administration (FHA) mortgage insurance were lost through foreclosure and resale as unassisted properties. This number would have been very much higher without the efforts of the Department of Housing and Urban Development (HUD) to deal with its troubled projects through Section 8 Loan Management Set-Asides, conversions of rent supplements to Section 8 assistance, flexible subsidies, and transfers of physical assets. In the event of foreclosure, HUD has generally attempted to retain projects in the assisted inventory by providing supplementary Section 8 assistance to their new owners. Generally, it appears that HUD has gone to considerable lengths to limit the number of units lost to the assisted inventory through involuntary retirement.

In the last year or so, it has for the first time become possible for reductions in the inventory of project-based assisted units to occur because of voluntary retirements. Voluntary retirements over the next ten years will involve the elimination of use restrictions when and if owners prepay the 40-year subsidized mortgages on the Section 221(d)(3) and 236 projects that were developed from the mid-1960s to the mid-1970s. Voluntary retirements thereafter will result when and if owners elect not to renew their Housing Assistance Payments Contracts with HUD for projects developed under the Section 8 New Construction and Substantial Rehabilitation programs in the late 1970s and early 1980s.

The potential for reducing the number of units receiving project-based assistance through involuntary retirements (prepayments and Section 8 opt-outs) is very significant when the number of eligible units is counted. The National Low Income Housing Preservation Commission's report estimated that of the 645,000 existing 221(d)(3) and 236 units, 367,400 will become eligible for prepayment by the year 2002.<sup>1</sup> Of these, the commission estimated that, without government intervention, 243,000, or 66.1 percent of all eligible units assisted under these programs, would be lost to the assisted inventory through voluntary retirement. The National Housing Preservation Task Force, in assessing the problem of both voluntary and involuntary retirement of units from the project-based assisted inventory, expressed its belief that:

The United States faces the risk of wide-scale social unrest, substantial losses to the FHA mortgage insurance funds and embarrassment in the world community, unless the Federal Government focuses on the problem in a positive manner so that most of this housing will be preserved for its original purpose.<sup>2</sup>

In view of the widely perceived gravity of the preservation issue and the crisis atmosphere created by the impending expiration date of the moratorium on prepayments, it may be useful to ask how this situation arose and what pitfalls Congress should try to avoid when it fashions a permanent solution to the "prepayment problem."

### **The economics and politics of prepayment**

Imagine — or recollect — a time when the government was committed to sponsoring the construction of new housing units so as to maintain or increase the number of project-based assisted units from year to year. The government would provide long-term

subsidy commitments through rental assistance payments and/or interest rate write-downs together with mortgage insurance. With the passage of time, there would be an inventory of units assisted in this manner. This inventory would increase, decrease, or remain level from year to year, depending on whether additions exceeded, fell short of, or were equal to retirements.

The government, by issuing mortgage insurance commitments, would underwrite the credit risk of each new project developed in this program. In some cases, the government would make bad underwriting decisions, projects would fail, and the government would lose money. In other cases, projects would do just fine; both their owners and the government would be happy to be in the program. In yet other cases, projects would do so well that owners would really like to give back to the government the long-term, rental-assistance subsidy commitments and the below-market interest rate mortgages just so they could make more money by renting the units at prices that more than compensated them for the lost subsidies.

Is there a prepayment problem here? On the contrary, there is a prepayment opportunity. The prohibition on prepayment of the mortgage can be regarded as a government asset when the alternative use value of the property appreciates. This asset can be “sold” to the owners of the appreciated properties by allowing them to “buy out” of the prepayment restriction. The freed-up subsidies and insurance commitments could be used to develop a new low-income property to replace the one that was lost. Proceeds from the buy out could be used to offset the mortgage insurance losses on the projects that failed and thereby reduce the cost of providing low-income housing.

A schedule of prepayment penalties would, under this approach, be incorporated in the original mortgage documents. Minimum levels for the penalty would be determined by the amount it would cost the government to replace the subsidies for the balance of the mortgage. On a straight interest-subsidy project and in the absence of any inflation in total development costs, between the time of the original mortgage commitment and the time of prepayment, the minimum prepayment penalty would be zero dollars. In the presence of inflation, the minimum prepayment penalty would increase with the inflation rate and would decrease with the elapsed time between mortgage commitment and prepayment.

By charging the minimum prepayment penalties, the government would be maximizing the rate at which existing subsidized projects

would be replaced by new subsidized units at no cost to the government. By charging a higher penalty amount, the government would be accepting a lower replacement rate, and the cost of assisted housing would be thereby reduced.

In a well-designed subsidy program for low-income housing, the right of an owner to buy out and the terms under which an owner may buy out are key elements. These terms should include adequate notice requirements to tenants and relocation-assistance payments. Because prepayments would, in such a program, both create additional housing units on a one-for-one basis and potentially reduce the costs of assisted housing, prepayment potential should be a positive factor in project selection.

Understanding the way prepayments might be structured in an ongoing subsidized-housing development program — but not in the 221(d)(3) and 236 programs — nevertheless provides some insight into the current prepayment problem.

If the statutory authority existed to develop replacement subsidized housing for subsidized buildings whose owners were willing to pay the prepayment penalties (no additional appropriations would be required), prepayment should properly be regarded not as a problem but, as noted earlier, as an opportunity to create additional housing units with no attendant reduction in the subsidized inventory.

Under these circumstances, which are relatively ideal compared with the current situation, it is reasonable to ask whether such a beneficent mechanism as purchased prepayment would be politically acceptable. Each time the owner of a medium-to-large, multi-family, subsidized-housing development prepays, there is likely to be a local news event in which the expressed sympathies are for the tenants who must find other housing. This will be true whatever arrangements are made to mitigate the effects of relocation. Thus, the authors of the 221(d)(3) and 236 programs, although they probably did not think too much about it at the time, effectively buried base closings, small political time bombs, with 20-year fuses, in almost every congressional district in the country.

The pressure to preserve the project-based assisted housing stock by averting prepayment draws its strength at the local level not so much from the demonstrated superiority of project-based assistance over voucher-based assistance, but from the understandable concern of those receiving housing benefits that they will be able to depend on these benefits for as long as they need them. This pressure

would exist even if every prepaying, assisted building were replaced by another assisted building of comparable quality. While society may be indifferent to which group of income-eligible families receives project-based assistance, the families themselves are by no means indifferent.

These factors will likely be more influential in the ongoing debate on the prepayment problem than many of the economic and housing concerns created by the issue of prepayment.

### **Preventing prepayment — how much is enough?**

If the inventory of project-based assisted housing is measured not in units, but in unit-years of firm owner commitments to provide low-rent housing, the prepayment-eligible buildings have already mostly left the inventory. As noted earlier, if it were not for the fact that there is currently no means of replacing these prepayment-eligible buildings and that there is no established exit price, they would probably not be missed. In fact, the only reason for talking to these building owners at all is that, local politics aside, as long as their buildings remain technically in the inventory, they are the only owners with whom HUD is authorized to talk and negotiate with about providing privately owned subsidized housing over the next 20 years or so.

Much of the prepayment debate at the national level reflects different views on the appropriate tradeoff between project- and voucher-based housing subsidies. The substitution of voucher-based subsidies for project-based subsidies under the Reagan Administration implied a view that voucher-based units were acceptable replacements for project-based units. While many housing professionals do not share this view, the project-based versus the voucher-based unit tradeoff can be used to structure a discussion of what the government should be prepared to pay to avoid prepayment.

Assume, for the moment, that one is indifferent to project-based and nonproject-based housing assistance. In this scenario, the government would not be prepared to pay any more for a project-based unit than for a voucher. For example, if a 221(d)(3) Below Market Interest Rate (BMIR) or 236 project, without rent subsidies, is eligible for prepayment, the *maximum* price the government should pay to keep it in the inventory for the remaining life of the mortgage would be the discounted cost of a 20-year housing voucher *less* the discounted cost of the remaining 20 years of interest subsidies, which would be avoided when the mortgage is prepaid.

The maximum price arrived at in this manner will differ from one project to another. It is possible, however, to establish an approximate range for the maximum price averaged across prepayment-eligible buildings. The discounted present cost of a 15-year voucher has been estimated to be \$30,000 (Office of Management and Budget) (OMB) and \$44,000 (Congressional Budget Office) (CBO).<sup>3</sup> Assuming a 5 percent inflation rate and an 8 percent discount rate, the discounted cost of a 20-year voucher should, therefore, lie in the range of \$37,500 to \$56,000. Interest subsidy payments for outstanding Section 236 mortgages were reported by CBO in 1987 to be approximately \$1,000 per unit per year.<sup>4</sup> Using these estimates, it is possible to arrive at a rough range for maximum prices that should be paid to retain prepayment-eligible units in the Section 236 program (table 1).

*Table 1. Range of Maximum Prices per Unit That Should Be Paid to Retain Prepayment-Eligible Units in the 236 Program (Assuming No Preference for Project-Based versus Nonproject-Based Assistance)*

Replacement cost of replacement voucher		Less savings in interest subsidy	Maximum price	
OMB	CBO		Low	High
\$34,500	\$56,000	(\$7,325)	\$27,175	\$48,675

Remember that the maximum prices in table 1 assume that these projects are receiving no rent supplements, no “deep subsidy” rental assistance payments, no Section 8 Loan Management Set-Asides, and no Section 8 assistance. To the extent that this is not the case, the maximum amounts should be further reduced by the 20-year per-unit costs of the supplementary assistance received.

This analysis is all predicated on a 1:1 tradeoff between project-based and nonproject-based assisted units. If the government believes that a 20-year project-based unit housing assistance commitment is worth two 20-year vouchers, then it simply doubles the voucher cost and deducts the interest subsidy to arrive at new maximum prices.

This approach would permit HUD Regional Office staff to calculate, using a worksheet and project-specific data, a maximum dollar amount that the government would be prepared to pay to prevent

each project from prepaying. It is the amount at which the cost of preventing prepayment equals the cost of issuing one or more 20-year replacement vouchers.

The next step would require HUD to classify each project according to the likelihood of prepayment if offered different prices to remain in the inventory. The three basic classes are as follows:

1. If offered no incentive, owner will not prepay.
2. If offered no incentive, owner will prepay; if offered maximum incentive, owner will not prepay.
3. If offered maximum incentive, owner will prepay.

This classification should be made completely mechanical based on calculation of the building's value at its highest and best alternative use. This calculation would require good, independent appraisals, together with current financial statements. It would be desirable to subcategorize class 2 above by considering whether or not an owner would prepay if offered 33 percent of maximum, 67 percent of maximum, or 100 percent of maximum. Mechanical application of these rules would then determine what amounts, if any, should be offered to induce each building's owner to stay in the program. All those in class 3 above would be offered the maximum even though they are not expected to accept.

How are the rules to be developed to arrive at this mechanical system of classification? Initial rules would be based on equalizing the discounted value of expected after-tax cash flow for the prepayment and nonprepayment options. Later, the experience of not making offers and experiencing prepayments, or of making offers and having them declined, would support further refinement of the way offer amounts are determined.

For several reasons, it seems very important that the prepayment offer amounts would not result from negotiations among HUD, building owners, local government officials, community organizers, and tenants' rights activists. In a project-by-project approach to the prepayment problem, HUD would arrive at independent determinations of what to offer each project owner on a take-it-or-leave-it basis. The alternative of project-by-project negotiations would completely politicize the process and create the appearance, if not the reality, of special dealings between HUD officials and building owners.

At this point, the system would determine, without any negotiations between HUD and the building owners, what it is worth to HUD to offer each owner in current dollars. It then becomes necessary to decide in what form these offers are to be made. The simplest approach would be to offer periodic payments to owners who agreed not to prepay. The present values of these payment streams would be equal to the values of the offers as calculated above. Because there is no existing statutory authority for such offers, most writers on the subject have chosen to structure prepayment offer packages within the framework of existing legislation.

The National Housing Preservation Task Force Report, for example, identified three kinds of financial incentives and three kinds of tax incentives that could be used:<sup>5</sup>

1. Increasing Allowable Distributions by allowing 6 percent distributions based on recalculated equity. This would lead to rent increases that would be shared between tenants and HUD where supplementary rent assistance was provided or where income from excess rents would be extinguished.<sup>6</sup>
2. Permitting owners to take equity out through secondary financing. This, again, would increase rents, and the cost would be shared both by tenants and by HUD.
3. Allowing low-interest loans for capital improvements through the flexible subsidy program. The cost to HUD would be the discounted cost of the interest subsidy. However, the level of funds available to the flexible subsidy program is limited, and its statutory purpose was to assist troubled, not untroubled, projects.

Both incentives 1 and 2 would clearly be strong incentives for building owners. Taken together, they would provide a mechanism whereby building owners could get immediate cash out of their buildings. In order to fine-tune the offers HUD makes to owners, HUD would decide the maximum percentage of the increased equity that could be used to support Increased Allowable Distributions. This maximum percentage would be higher for the buildings deemed most likely to prepay.

It appears that increases in allowable distributions would, in many cases, be adequate to provide building owners with cash roughly equal to the maximum price that HUD should be prepared to pay to retain those buildings in the inventory of assisted housing. The National Housing Preservation Task Force Report<sup>7</sup> gives an

example of a property where the allowable distribution per unit increases from \$99 to \$1,680 per year. The present value of this increase in cash flow at an 8 percent discount rate is \$15,522. This corresponds to approximately 50 percent of the low estimate of the maximum price presented above.

The Task Force Report also identifies three changes in the tax code that might provide incentives to prepayment-eligible owners. They include reestablishment of the owner's depreciable tax basis at its highest and best use appraised value, use of low-income tax credits for existing owners, and elimination of capital gains taxes on sales to public and nonprofit entities. All are blunt and indiscriminating tools. They could not be used by HUD to adjust the offer amounts to reflect the likelihood of prepayment; they would be much more expensive in terms of lost tax revenues than any of the direct expenditure approaches; and they would further complicate the tax code. Furthermore, the use of the low-income tax credit for existing owners would be inconsistent with the purpose of the code — to stimulate low-income housing production. This goal should not be subordinated to the wish to retain existing units in low-income use.

## Summary

Prepayment eligibility has become a real housing problem because of the termination of the Section 8 New Construction and Substantial Rehabilitation programs in the mid-1980s. Since then, the inventory of project-based assisted housing has declined somewhat as a result of foreclosures and despite HUD's serious commitment to its troubled projects. The inventory is now threatened with potentially larger declines as many of the 221(d)(3) and 236 for-profit projects become eligible for prepayment and subsequent termination of use restrictions.

Under conditions in which the federal government stands ready to replenish the inventory of project-based assisted housing when losses occur, prepayment at a price to the owner can create substantial housing benefits by creating additional unsubsidized housing units every time a prepayment occurs and by generating prepayment penalty income that can be used to offset mortgage insurance losses.

It is necessary to recognize, however, that even under ideal circumstances, prepayment may generate political opposition at the local level and that this, in turn, will have repercussions in Congress. Under the much less than ideal conditions now prevailing, with no

replacement project-based housing available and with no buy out arrangements in place, it is apparent that federal policy must attempt, as a matter of political necessity, to limit the extent of prepayment by the owners of subsidized projects over the next few years.

In considering how HUD should implement such a policy, this paper has presented an approach for establishing a maximum price that the government should be prepared to pay to induce each prepayment-eligible building owner not to prepay. This maximum would be the difference between the present cost of one (or more) 20-year housing voucher(s) and the present cost of the mortgage interest and rental subsidies, if any, for which the government would otherwise be responsible. All prepayment-eligible buildings would then be classified in terms of the amount that HUD would be prepared to pay, up to the calculated maximum amount. The classification would attempt to determine the minimum payment necessary to retain a building in the inventory and would be based on independent appraisals of the building's highest and best use value and on the building's financial statements.

The cash amounts that HUD would be willing to offer to avert prepayment and to secure renewed 20-year existing use restrictions would be converted into increases in Allowable Distributions up to a HUD-determined percentage of the increase in recalculated equity. Owners would also be permitted to take equity out through secondary financing, subject to reasonable underwriting standards.

The most challenging aspect of the approach outlined in this paper is the administrative burden it places on HUD. The suggested process has been automated to the maximum degree possible. The offers made to each owner would be based on objective financial data and on independent appraised valuations. These data would then be processed by predetermined formulae to determine the offers to be made to owners. The formulae would be designed to minimize HUD's cost in retaining units that would otherwise prepay. The offers would be made, and would be either accepted or declined — and that would be the end of it. Negotiations between HUD and building owners in which HUD employees have authority to cut deals should be completely avoided. To do otherwise would be to place a totally unreasonable burden on HUD and its employees.

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## *Endnotes*

1. *Preventing the Disappearance of Low-Income Housing* (Washington, DC: The National Low Income Housing Preservation Commission, 1988), C-14-15.
2. *The Preservation of Low and Moderate Income Housing in the United States of America* (Washington, DC: The National Housing Preservation Task Force, 1988), 7.
3. *Preventing the Disappearance*, C-6.
4. "The Potential Loss of Assisted Housing Units as Certain Mortgage Interest Subsidy Programs Mature" (Staff Working Paper, Congressional Budget Office, Washington, DC, March 1987).
5. *Preservation of Low Income Housing*, 20-22.
6. Excess rents are the differences between "basic" and "market" rents and are paid by the owner to HUD.
7. *Preservation of Low Income Housing*, 20.

