

The Dilemma of the Disposition of Troubled FHA-Insured Multifamily Rental Property

James E. Wallace
Abt Associates, Inc.

Abstract

Attention has been increasingly focused on multifamily rental properties insured by the Federal Housing Administration (FHA) that have fallen into default and had their mortgages assigned to the U.S. Department of Housing and Urban Development (HUD), in many cases leading to HUD's taking outright possession before reselling the property to a private owner. A fiscal and policy crisis has arisen around both the net costs of foreclosure to the FHA insurance fund itself and the lack of discretionary subsidy funds to assist all the eligible tenants in the large number of eligible properties.

This article takes the point of view that improvements need to be made in the way these properties are monitored by HUD and in the flexibility given HUD in assisting owners of troubled properties to avoid foreclosure.¹

Background

The public policy debate over assisted housing strategies has revolved around when federal assistance should be linked to specific projects and when it should be tenant based, allowing the recipient to choose where to use the subsidy. This debate takes place in a budget environment in which many more households would qualify for assistance than the available funds could assist; that is, the United States does not have an entitlement housing assistance policy.

The current problem of the disposition of foreclosed multifamily housing insured by the Federal Housing Administration (FHA) and the many properties owned by the U.S. Department of Housing and Urban Development (HUD) embodies both of these policy dilemmas. Current law requires that additional housing assistance be provided to tenants in these troubled projects as a condition of their sale by HUD. Yet, reflecting the discretionary

¹ After this article was written, Congress passed the Multifamily Property Disposition Reform Act of 1994, which has a bearing on the issues discussed herein. For a fuller explanation of the act and its provisions, see the addendum on page 31.

budget ceilings under which HUD must operate and the non-entitlement nature of U.S. housing assistance, the funds needed to meet this requirement have been neither requested by HUD nor appropriated by Congress. Even if sufficient housing subsidies were available to carry out the congressional directives regarding disposition of these properties, there remains the important policy issue of whether this project-based approach would be the most effective use of new subsidy funds. Before addressing the current property disposition issue, this article first reviews the context of nonentitlement, then summarizes the size and condition of the FHA-insured stock of multifamily rental housing as well as several estimates of the threat of default in this stock.

Nonentitlement: The broader context of housing need

The dilemma of what to do about foreclosures and HUD-owned properties occurs in a more general context of housing need. Although federal budgets continue to make marginal additions to the number of renters assisted, these additions have been offset by increasing numbers of households dropping into poverty and by the loss of unsubsidized housing that is affordable to low-income households. This problem has been repeatedly pointed out (see Apgar 1991; Apgar and Brown 1988; Apgar et al. 1990; Clay 1987; Joint Center for Housing Studies of Harvard University 1993; National Association of Home Builders 1986).

The *State of the Nation's Housing: 1993* (Joint Center 1993) used Census Bureau and American Housing Survey (AHS) data to develop a picture of this balance. As shown in table 1, of the 6,048,000 extremely low income renter households (with incomes under 25 percent of the local median), 2,266,000 (37 percent) were receiving federal housing assistance in 1991. The Joint Center defined households without a severe housing problem as those living in "structurally adequate" housing² and paying gross rents amounting to less than 50 percent of household income. By this definition, 292,000 of the unsubsidized extremely low income renters did not have a severe housing problem, leaving 3,490,000 with no housing assistance and with a severe housing problem (physically inadequate housing, a rent burden of 50 percent or more of income, or both). Defining the

² The Joint Center defines housing inadequacy in terms of the presence or absence of plumbing fixtures, heating equipment, and other mechanical subsystems as well as information on the repair and upkeep of properties (Joint Center 1993, 32).

*Table 1. Gap in Housing Assistance for Renters
(in thousands of households)*

Income Relative to Local Median	Total	Assisted	Unassisted		
			Adequate Housing and Rent under 50% Income	Adequate and Rent \geq 50% Income	Inadequate
Under 25%	6,048	2,266	292	2,657	833
25% to 50%	6,814	1,399	2,738	1,805	872
Cumulative up to 50%	12,862	3,665	3,030	4,462	1,705
50% to 80%	6,743	440	5,061	497	745
Cumulative up to 80%	19,605	4,105	4,989	4,959	2,450

Source: Joint Center for Housing Studies of Harvard University, 1993, table A-11, based on tabulations from the 1991 American Housing Survey.

assistance gap in this way, another 2,677,000 renters in the income range of 25 to 50 percent of the local median lack needed housing assistance, and those in the income range of 50 to 80 percent of median add another 1,242,000. For most of the unassisted households with severe housing problems, the issue is affordability. Among unassisted households under 50 percent of median income, 4,462,000 have adequate housing but pay rents 50 percent or more of income, leaving 1,705,000 with inadequate housing.

Nelson and Khadduri (1992; Khadduri and Nelson 1992) have argued that, in the absence of an entitlement program for housing assistance, the available subsidy funds should be targeted to the “worst-case” households. In 1979 and 1983 Congress attempted to target housing assistance to the neediest households by legislating admission preferences for households with particularly severe housing-related problems. Those to be given preference were unassisted households paying more than half their income for rent, living in seriously substandard units (HUD uses a definition, based on AHS questions, of “severe physical problems”), or involuntarily displaced. Since the mid-1980s, HUD has reported to Congress on the number of worst-case households, using data from the AHS. In the 1991 report (based on 1989 AHS data), 3.6 million unassisted elderly or family very low income (under 50 percent of median) renter households had priority worst-case housing problems (HUD Office of Policy Development and Research 1991). Because the National Affordable Housing Act of 1990 redefined “families” to include single persons for programs administered by HUD, the report also counted as worst-case another 1.4 million very low income renter households that had severe problems but contained only

non-elderly unrelated individuals.³ (The 1992 HUD report used the metropolitan area samples of the AHS and identified the location of worst-case needs in the late 1980s.) In the 1990 National Affordable Housing Act, Congress began to back away from strict targeting in rental assistance (Section 8 and public housing) by increasing the percentages of households that can be selected from waiting lists ahead of those with the so-called federal preferences. By a rough accounting, covering all the HUD-defined worst-case unassisted very low income renter households would require \$25 billion annually (5 million households at roughly \$5,000 per unit per year in Section 8 rental assistance).

The fact that U.S. housing assistance is not an entitlement for eligible low-income households complicates the issue of property disposition. If all eligible low-income households were entitled to housing assistance, assistance to ensure affordability would not be an issue, and the problem of the disposition of the foreclosed and HUD-owned stock of HUD-insured housing could be treated directly on the basis of minimizing federal losses in the process and of benefits to be derived from community preservation and development. In the absence of entitlement, housing advocates successfully argued in the debate leading to the 1987 amendments to Section 203 of the Housing and Community Development Act of 1978 not only that currently assisted households should be held harmless—that is, not lose their subsidy in a conversion—but also that additional units should have subsidies attached as a condition of HUD’s having had responsibility for the insurance (and assistance) for the properties.

Concerns for preservation

In 1987 much attention was being focused on the issue of preservation of the country’s affordable housing stock. Of particular concern were the portions of the rental stock that had been made affordable through federal programs. These included the following:

³ The 5 million worst-case very low income renter households in the HUD report are fewer than the 6.2 million households (3.5 million under 25 percent of median income plus 2.7 million with incomes between 25 and 50 percent of median income) in the Joint Center work, apparently because the Joint Center definition of “inadequate housing” is broader than the HUD definition of “severe physical problems.” Both defined a severe rent burden as paying more than 50 percent of income for gross rent, and both based their numbers on the AHS; HUD used the 1989 survey and the Joint Center 1991 survey, but the time difference is not a likely source of major differences.

1. The “older assisted” housing that was provided under the below-market interest programs of the 1960s and 1970s (assisted under Section 221(d)(3) and Section 236 programs) but that carried a contractual requirement for operation as low-income housing for only 20 years (see Clay and Wallace 1990; National Low-Income Housing Preservation Commission 1988; U.S. Congressional Budget Office 1987)
2. Projects established with project-based Section 8 subsidies, whose contracts eventually expire and are vulnerable to both lack of subsidy funds and owners’ lack of interest in continuing in the program (see U.S. General Accounting Office 1987)
3. HUD-insured properties that were foreclosed and owned or sold by HUD

The debate about renewing subsidies and the magnitude of automatic rent increases for the Section 8 projects is ongoing. Congress, out of concern both for the low-income tenants who would be affected by transitions in ownership and for preserving the availability of affordable housing, included in the Housing and Community Development Act of 1987 provisions to deal with two of these concerns. In the case of the older assisted properties, Congress passed a temporary measure, the Emergency Low-Income Housing Preservation Act, essentially prohibiting owners from converting these properties to market-rate units and providing incentives to owners to maintain their units as assisted housing.⁴

With respect to the perceived problem of properties in foreclosure or owned by HUD, in the 1987 amendments to Section 203 of the Housing and Community Development Act of 1978, Congress required that HUD either reduce the selling price or provide subsidies for low-income tenants, so that a new owner could make these properties affordable. Specifically, these amendments included the following requirements (to the extent budget authority is available):⁵

⁴ This temporary legislation was superseded by Title VI of the 1990 National Affordable Housing Act, named the Low-Income Housing Preservation and Resident Homeownership Act, which essentially provided a means for recapitalizing those properties with an unassisted value higher than the mortgage balance and committing these units to low-income housing for their “remaining useful life,” construed in the statute as at least 50 years.

⁵ Some limited and seldom-used exceptions to the preservation requirements were allowed: Specifically, HUD could cover with five-year Section 8 rental assistance those eligible tenants residing in a formerly unsubsidized project

1. In *subsidized or formerly subsidized* projects—those with interest subsidy, Section 236 and Section 221(d)(3) projects, properties already having project-based Section 8 rental assistance, and properties under other sections of the act with more than 50 percent of tenants in units subsidized by Section 8 (e.g., through the Section 8 loan management set-aside [LMSA] program)—HUD was to provide 15-year Section 8 project-based rental assistance covering all units (not just those already subsidized).
2. In *unsubsidized* projects—those receiving no mortgage-related subsidy or receiving housing assistance payments for fewer than 50 percent of the units—HUD was to provide Section 8 rental assistance contracts for 15 years for all units occupied at the time of foreclosure or sale by low-income tenants, as well as for vacant units. A property with no tenants eligible for rental assistance could be sold without preservation requirements.

This 1987 legislation represented a focus on preservation—maintaining properties as assisted and expanding the number of assisted units in these properties. From a federal budget perspective, however, these obligations created an unpredictable set of demands not only to provide additional rental subsidies but to provide them in the FHA-insured projects that failed, wherever they happened to be and however appropriate they might be as affordable housing. Furthermore, not enough additional funds have been appropriated to satisfy these requirements for all the properties that are now eligible, not to mention the continuing foreclosures. Thus, HUD owns a growing inventory of properties it would prefer to sell to private owners but cannot afford to sell because of the requirement to convey the properties as affordable housing, which essentially requires tenant subsidies. Before turning to the specific issues of default and property disposition, some background is presented on how well FHA-insured multifamily housing is serving low-income households and on the threats to this stock.

Size of the FHA-insured stock

More than 13,000 privately owned multifamily rental properties in the United States have FHA insurance, providing

in an area where adequate affordable housing was available; preservation requirements could be waived if extreme circumstances rendered it imprudent or unreasonable to preserve the property for use by low- to moderate-income tenants; and HUD could reduce the sales price in return for a commitment by the new owner to make available a specified number of units at reduced rents.

housing to more than 1.5 million households and exposing the FHA insurance fund to more than \$34 billion in insurance obligations.⁶ The problem of failures of HUD-insured properties has been developing for years as the stock of those properties has aged and as subsidy and tax issues have complicated the provision of support for these rental properties. An alarmingly large and growing number of these mortgages are now held by HUD, generally assigned to HUD by the original lender when the owner became delinquent in mortgage payments.⁷ Some of these properties will be rescued through “workouts” with HUD to restabilize them financially and physically, but HUD generally will continue to hold the mortgage.⁸ Others will not be rescued in this way and will go into foreclosure, to be sold to a third party or acquired for a period by HUD before being sold to another owner, with HUD recapturing as much of the insurance liability as possible in the resale, net of all the holding and transaction costs.

This situation not only places demands on the FHA insurance fund but also puts at risk a large number of lower income households living in these properties. More than 90 percent of tenants in insured properties have incomes below the local median, including 68 percent with incomes below half the local median. It is useful to divide this stock into three distinct categories (Wallace et al. 1993):

1. *Unassisted properties* are properties insured under any HUD mortgage insurance program that receive no HUD subsidy (no rental assistance and no mortgage interest subsidy). This category includes 3,080 properties housing

⁶ These figures are from Wallace et al. (1993). The universe of projects for that study excluded a number of special categories of multifamily properties: properties not in the contiguous 48 states or the District of Columbia and properties in remote rural counties; properties with public housing authority, public body, or condominium owners; coinsured properties; nursing homes; mobile homes; veterans’ and war housing; properties whose titles had been acquired by HUD; Section 202 loan projects; Section 312 rehabilitation loan projects; and uninsured state Section 236 and uninsured Section 8 projects. The base of 15,081 total properties provided for reference in the later figures on HUD-held mortgages and HUD-owned properties excludes only Section 202 and Section 312 properties.

⁷ A reviewer pointed out that some 400 mortgages under Section 221(g)(4) were current on their payments before being assigned.

⁸ HUD is working on possible programs to resell these performing loans and is considering selling nonperforming loans at a discount.

some 452,000 families. Even these properties represent a resource for affordable housing. Although there are no rent or income requirements for unassisted properties, 22 percent of these families had very low incomes (below 50 percent of the local median), and 37 percent had low incomes (50 to 80 percent of the local median). Most unassisted properties have mortgages insured under the Section 221(d)(4) multifamily rental housing program.⁹

2. *Older assisted properties* are properties insured under any HUD mortgage insurance program that receive either mortgage interest subsidies (under the Section 236 or 221(d)(3) below market interest rate insurance programs) or rental assistance under the Section 8 LMSA, rent supplement, rental assistance payment, or Section 8 property disposition programs. (Most of the properties receiving rental assistance are insured under the Section 221(d)(3) market interest rate program.) Older assisted properties include 6,037 properties housing some 674,000 families. Nearly all residents in these properties had incomes below 80 percent of the local median: 77 percent had incomes below 50 percent of the median, and another 17 percent had incomes between 50 and 80 percent of the median. These properties were generally insured between the late 1960s and the mid-1970s, and many are in need of repair.
3. *Newer assisted properties* are properties insured under any HUD mortgage insurance program that receive rental assistance under one of the following Section 8 programs: new construction, substantial rehabilitation, or moderate rehabilitation. (Most of these properties have mortgages insured under the Section 221(d)(4) program.) Newer assisted properties include 4,154 properties housing some 362,000 families. Most residents (90 percent) had very low incomes (under 50 percent of the local median), and another 8 percent had low incomes (50 to 80 percent of the median). Newer assisted properties (insured after the 1974 Housing Act) have the highest mortgages and interest rates (because they were built under the prices and interest rates of the late 1970s and early 1980s) but the newest physical systems.

⁹ Other sections of the housing act with unassisted properties include Section 207 multifamily housing, Section 220 urban renewal, Section 231 elderly, and Section 221(d)(3) market interest rate.

Condition of the FHA-insured stock

HUD commissioned a study by Abt Associates (Wallace et al. 1993) to obtain information on the physical and financial condition of the FHA-insured stock. This information provides some clues about which projects may be headed for trouble. The study computed a *Distress Index*—a combined indicator encompassing both a property’s net cash flow and its unfunded backlog of physical needs. The purpose of the Distress Index was to identify properties lacking the financial resources to make needed repairs and meet normal operating and maintenance expenses. The Distress Index was computed as a modified annual net cash flow per two-bedroom-equivalent unit, as follows:¹⁰

Net cash flow (three-year weighted average)

- Amortized cost of remedying unfunded backlog of physical needs¹¹
- + Added income from reducing vacancy losses.¹²

¹⁰ All physical needs and financial resources are expressed in 1989 dollars per two-bedroom-equivalent dwelling unit (844 square feet).

¹¹ One would not normally expect a property that had accumulated over a number of years an unfunded backlog of physical needs (needs for major capital repairs and replacements not covered by available project reserves) to pay for a repair program all at once. The Distress Index computation amortizes the backlog by assuming that owners take out a loan at 9 percent interest over 20 years to cover unfunded repairs. This is equivalent to paying 10.8 percent of the backlog each year for 20 years, since 10.8 percent is the debt service factor on a 9 percent, 20-year loan. This loan amortization is meant to simulate the combination of ways an owner might spread remedial repair costs over time, such as

1. Staging repairs and replacements over time, beginning with highest priority items
2. “Borrowing” from creditors by deferring full payment of the property’s obligations (especially those to firms related to the owner, such as identity-of-interest property management, accounting, legal, or plumbing firms)
3. Deferring a portion of mortgage debt service (with HUD’s approval)
4. Providing advances to the property from the owner’s own funds (or from loans secured by the owner and not the property)
5. Taking out a loan secured by the property

¹² This adjustment applies only to high-vacancy properties. The Distress Index computation assumes that improvements in physical condition or operations

The resulting Distress Index would be highly negative (a deficit) for properties having very high unfunded physical needs backlogs, very high negative net cash flows, or some combination of the two. The report divides properties into three groups on the basis of their Distress Index values:

1. *Sound properties (Distress Index zero or positive)* apparently have sufficient resources to cover operations, debt service, deposits to reserves for replacement, and amortization of the current physical needs backlog.
2. *Stressed properties (Distress Index deficit up to \$250)* seem likely to develop serious problems in the absence of improved income or operations. Properties assisted through Section 8 may be able to obtain rent increases to close the gap. Other properties may be able to survive shortfalls of this magnitude in the short run by juggling payment of obligations and cutting corners.
3. *Distressed properties (Distress Index deficit exceeding \$250)* face a severe resource shortfall and are at risk of failing to remedy critical backlog items, fund essential operations, or pay full mortgage debt service. The \$250 deficit threshold would be equivalent to any of the following conditions: having to amortize a \$2,300 unfunded backlog, being short on cash flow by 9 percent of average operating expenses, or needing monthly rent increases of more than \$21 per unit (more than a 9 percent increase in tenant-paid rents in assisted properties). Any of these conditions is likely to constitute a major problem.

Nearly a quarter of all FHA-insured properties were distressed—3,168 properties housing more than 380,000 households. Another 1,816 properties were stressed. The application of this Distress Index to the HUD multifamily stock is summarized in table 2:

- Overall, 24 percent of properties were distressed, 14 percent were stressed, and the remaining 62 percent were sound.
- Thirty-one percent of older assisted properties and 30 percent of unassisted properties were distressed, compared with only 9 percent of newer assisted properties.

will enable properties whose vacancies rank in the highest 25 percent for their assistance category to reduce their vacancy level to that of the 75th percentile, and properties whose vacancies are already below this level (but are above the median for their assistance category) to reduce them to the median.

Table 2. Distress Index by Assistance Category, Multifamily Rental Housing with HUD-Insured (or Held) Mortgages

	Total	Total		Assisted	
		Unassisted	Assisted	Older Assisted	Newer Assisted
Total properties	13,271	3,080	10,191	6,037	4,154
Percent of properties	100%	23%	77%	59% ^a	41% ^a
Distressed	24%	30%	23%	31% ^b	9%
< "\$1,000	6%	12%	4%	6%	1%
"\$1,000 to < "\$500	9%	10%	9%	12%	3%
"\$500 to < "\$250	9%	8%	10%	13%	5%
Stressed	14%	10%	15%	21% ^b	6%
"\$250 to \$0	14%	10%	15%	21%	6%
Sound	62%	60%	63%	49% ^b	85%
\$0 to < \$250	20%	15%	21%	26%	14%
\$250 to < \$500	13%	9%	15%	13%	18%
\$500 to < \$1,000	13%	8%	14%	5%	28%
≥ \$1,000	16%	29%	13%	5%	25%
Statistics on distress index					
Mean	\$276	\$293	\$271	\$28 ^b	\$625
Standard error	\$82	\$326	\$55	\$75	\$62
Median	\$145	\$184	\$142	"\$20	\$530

Source: Data from exhibit 3.1 in Wallace et al. 1993.

Note: See text for explanations of Distress Index ranges. Column sums may not add to 100 percent because of rounding.

^a Percentages in the older and newer assisted categories total 100 percent of the total assisted category's 77 percent. Older assisted properties make up 45 percent of the universe, and newer assisted properties 31 percent.

^b Difference between the older assisted and newer assisted properties is statistically significant at the 95 percent level. The differences between assisted and unassisted properties are not statistically significant.

- Twenty-one percent of older assisted properties were stressed, compared with only 10 percent of unassisted properties and 6 percent of newer assisted properties.

The study's inspectors rated 68 percent of distressed and 88 percent of stressed properties as being of excellent or good overall quality (compared with 94 percent of sound properties). Looming backlogs were not necessarily influencing perceived current quality.

Not surprisingly, the problems of the backlog of physical needs and of the lack of sufficient internal resources to cover these needs were concentrated among the distressed properties, as indicated in table 3. The 3,168 distressed properties in the entire multifamily rental stock had a combined unfunded backlog of physical needs of \$898 million (in 1989 dollars); the 1,816 stressed properties had a combined unfunded backlog of \$286 million. Thus the combined unfunded backlog for distressed and stressed properties was nearly \$1.2 billion.¹³ This estimate of *current* unfunded backlog does not include unfunded future annual accrual of physical needs, which are estimated to average another \$560 million a year across the entire HUD-insured stock.¹⁴

Assisted properties constitute a major portion of the distressed and stressed multifamily stock. There were 2,258 distressed assisted properties (containing 229,235 two-bedroom-equivalent units) and 1,494 stressed assisted properties (containing 162,662 two-bedroom-equivalent units). Distressed assisted properties had a total needs backlog of \$786 million, of which \$708 million was unfunded. Stressed assisted properties had a total needs backlog of \$292 million, of which \$247 million was unfunded. Thus, the combined unfunded needs backlog of assisted properties that were either distressed or stressed was \$955 million.¹⁵

¹³ The backlog for sound properties is omitted from these figures because sound properties were presumed to have sufficient internal resources (from their reserve accounts, cash flow, and potential operating improvements) to cover their backlogs while continuing to make deposits to their reserve accounts to cover future physical needs. There were 8,287 sound properties containing 834,720 two-bedroom-equivalent units. These properties had a total backlog of \$707.4 million, of which \$452.4 million was unfunded. These properties should be able to make all necessary repairs and replacements without additional federal assistance.

¹⁴ Apart from any current backlog of physical needs, properties will require future capital repairs, above and beyond normal maintenance. To the extent that these future needs cannot be met with resources internal to the property, these needs were estimated by the study as *accrual of (future) physical needs*. A property's physical needs accruals are estimates of the average annual costs needed to cover expected repairs and replacements for all systems over each of the next 20 years. The projected average annual accrual of physical needs was estimated as \$795 per two-bedroom-equivalent unit for unassisted properties, \$872 for older assisted properties, and \$800 for newer assisted properties. The computation of unfunded future annual accrual reflects the fact that replacement reserve deposits and net cash flow would offset at least some of these costs.

¹⁵ There were 6,439 sound assisted properties containing 602,415 two-bedroom-equivalent units. These properties had total physical needs backlogs of \$530.4 million, of which \$302.4 million was unfunded. However, as was true

Table 3. Total Backlog and Unfunded Backlog of Physical Needs by Distress Index, Multifamily Rental Housing with HUD-Insured (or Held) Mortgages

	Total	Distressed (Index < "250)	Stressed (Index between "250 and \$0)	Sound (Index > \$0)
Total properties	13,271	3,168	1,816	8,287
Percent of properties	100%	24%	14%	62%
Total backlog per 2BR unit				
<\$10	20%	16% ^a	12% ^b	23%
\$10 to <\$500	25%	9% ^b	15% ^b	33%
\$500 to <\$1,000	13%	7% ^b	18%	14%
\$1,000 to <\$2,000	17%	13%	22%	18%
\$2,000 to <\$3,000	8%	12% ^b	15% ^b	6%
\$3,000 to <\$4,000	6%	8%	12% ^b	4%
\$4,000 to <\$5,000	4%	8% ^b	5%	2%
\$5,000 to <\$7,500	5%	16% ^b	2% ^b	1%
≥\$7,500	2%	10% ^b	0%	0%
Mean	\$1,520	\$3,273 ^b	\$1,581 ^b	\$837
Standard error	\$92	\$274	\$157	\$64
Median	\$654	\$2,311	\$1,269	\$341
Unfunded needs backlog per 2BR unit				
\$0	44%	21% ^b	25% ^b	57%
\$0 to <\$500	14%	11%	11% ^a	15%
\$500 to <\$1,000	10%	7%	17% ^b	9%
\$1,000 to <\$2,000	11%	10%	19% ^b	10%
\$2,000 to <\$5,000	15%	28% ^b	26% ^b	8%
\$5,000 to <\$7,500	5%	16% ^b	1% ^b	1%
≥\$7,500	2%	7% ^b	0% ^b	0%
Mean	\$1,214	\$2,999 ^b	\$1,284 ^b	\$516
Standard error	\$88	\$268	\$152	\$54
Median	\$228	\$2,156	\$744	\$0
Total all properties (in millions)	\$1,184	\$898	\$286	— ^c

Source: Data from exhibit 3.6 in Wallace et al. 1993.

Note: Column sums may not add to 100 percent because of rounding.

^a Differences between distressed and sound or stressed and sound properties are statistically significant at the 90 percent level.

^b Differences between distressed and sound or stressed or sound properties are statistically significant at the 95 percent level.

^c The backlog for sound properties is omitted because said properties were presumed to have sufficient internal resources (from their reserve accounts, cash flow, and potential operating improvements) to cover their backlog while continuing to make deposits to their reserve accounts to cover future physical needs.

of sound properties in the entire multifamily stock, these sound properties have sufficient internal resources to cover their full backlogs without additional federal assistance.

These unfunded current backlogs represent an upper limit on the amount of additional federal resources (from sources external to the property) these distressed and stressed properties would require to restore all physical systems to sound condition. A portion of these current backlogs could be covered from cash flow, increases in rent and occupancy, loans, cash advances from owners, and grants from local or state programs. Again, possible resolution through these future streams is complicated by the demands of the ongoing accrual of repair needs as systems age, wear out and need replacement, or simply need major periodic overhaul to continue providing a decent level of housing services to the tenants.

What remedies do these distressed and stressed properties have?

1. Many properties have positive cash flow that could be applied toward remedying the physical backlog.
2. Many properties could fund some of their backlog by improving cash flow.
3. Owners of some unassisted properties could reap higher rents and occupancy by investing their own funds in remedying backlogs.
4. A minority of properties have extremely high backlogs that, from the federal budgetary standpoint, may not be cost-effective to remedy relative to other options.
5. For some distressed properties, lack of an owner willing to cooperate may make it impossible to undertake an effective program of physical improvements. While HUD may resort to administrative and legal sanctions to motivate some uncooperative owners and may be able to have others replaced, in some situations (such as weak local market conditions, limited financial potential of a property) it may be difficult for HUD to install an owner who will undertake an effective physical improvement program even with HUD assistance.

Thus, distressed or stressed properties are not necessarily bound for foreclosure. Rent increases are available to some. Many of these properties are eligible to apply for HUD's existing remedial assistance programs, Section 8 LMSA, flexible subsidy operating loans, and flexible subsidy capital improvement loans; some are eligible for preservation incentives. Some owners might be able to sell these properties to a tax credit converter. Future

disposition of these properties thus depends on a balancing of many influences and options open to owners and HUD.

Estimates of possible defaults

Estimates for the National Low-Income Housing Preservation Commission

Explicit attention was paid to the threat of default-based losses in the older assisted rental stock in the simulation model results developed for the National Low-Income Housing Preservation Commission (1988). The commission's report indicated that, over the period 1988 through 2004, 2,570 older assisted properties with 280,000 units (chiefly properties under the Section 236 interest subsidy and Section 221(d)(3) below-market interest rate programs) could default if no intervention were made and subsidy contracts were allowed to expire.

Estimates from the Abt multifamily study for HUD

As part of the HUD-sponsored study, Abt Associates further developed this simulation model and applied it to projecting the future status of all the FHA-insured multifamily rental properties and the future government and private costs involved in assistance to or foreclosures of these properties.¹⁶ The simulation uses information collected on the study sample of properties; incorporates internal logic to approximate federal program laws and regulations; and (through variable input parameters) allows the user to approximate federal program budget availability, general economic conditions, and borrowing terms.

Preliminary results indicate that over the next 20 years the titles to roughly 2,600 HUD-insured multifamily properties will be resigned by the owner or foreclosed on by HUD. The model results for property status across a 20-year period predict that 18 percent of unassisted properties (560 properties with 75,000 units) will suffer foreclosure at some point during the 20 years. Thirty-three percent of older assisted properties (nearly 2,000 properties with 202,000 units) are predicted to suffer foreclosure during this period. Among newer assisted properties, only 1 percent (28 properties with 5,600 units) are predicted to suffer foreclosure.

¹⁶ The simulation model results are summarized in a forthcoming journal article (Wallace 1994). The complete results are in the HUD contract report (Wallace 1992).

The simple 20-year undiscounted sum of net FHA insurance fund losses and holding costs is computed by the model as \$3 billion. The model projection of the undiscounted sum of Section 8 property disposition set-aside costs needed to satisfy all requirements is \$10 billion.¹⁷

Estimates by the General Accounting Office and Coopers & Lybrand

The public focus on the problems of HUD-insured properties heightened in mid-1993. Congressional testimony in May 1993 by the U.S. General Accounting Office (GAO 1993) indicated that the inventory of HUD-owned units had grown from 10,000 in 1990 to 27,000 in 1992—with HUD in the process of foreclosing on 42,000 more units. The GAO testimony raised the concern that this growth generates demands for Section 8 subsidies well in excess of the amounts appropriated and leaves HUD “the landlord for a huge inventory of properties—a role that HUD was never intended to play nor has it been adequately staffed to fulfill.”

On the heels of this disclosure, news articles appeared (*New York Times* 1993; *Washington Post* 1993) about a report prepared by Coopers & Lybrand (1993) for the HUD Office of Mortgage Insurance. The Coopers & Lybrand investigation raised the specter of massive demands on the FHA insurance fund over the next few years, ranging from a discounted present value of \$8.8 billion to \$11.3 billion, depending on assumptions about loans graded by Coopers & Lybrand as “bad” (1,686 properties), “poor” (2,572 properties), or “average” (3,758 properties).¹⁸

¹⁷ These figures are the simple undiscounted sum of the in-year budget requirements computed by the model. They are only roughly comparable with the HUD estimate, presented later in this article, that it would take five years and \$5.4 billion in Section 8 budget authority for HUD to catch up and be in a position to handle regular processing of annual additions to foreclosures and the HUD-held inventory.

¹⁸ The Coopers & Lybrand study addressed a universe of 13,852 properties, not including coinsured and hospital programs. The grading scheme used was calibrated to HUD field office judgments about properties deemed “troubled” and used file reviews of 1,765 properties and on-site physical inspections of 250 properties. A reviewer noted that the estimated future demand on the FHA insurance fund was \$11.9 billion in FHA’s audited financial statement prepared by Price Waterhouse.

HUD estimates of the current disposition load

Estimates of large numbers of future defaults not only heightened concerns about demands on the federal budget that would be required to make up annual losses from the FHA insurance fund, but also raised the additional concern that HUD, currently lacking subsidy funds to process the properties already held, would be further inundated with properties for which it would lack the subsidy funds to sell them to new owners. In table 4 are presented the year-end numbers of mortgages held by HUD, properties in foreclosure, and properties owned by HUD over recent years.¹⁹ They show a steady growth in all these categories, as HUD is unable either to stem the tide of foreclosures or to quickly sell those properties that go into foreclosure. The flow of HUD-insured properties into and out of foreclosure as they are taken to sale, to be either sold to a third party or acquired by HUD, is outlined in table 5.

Table 4. Recent Buildup in HUD-Held Mortgages, Properties in Foreclosure, and Properties Owned by HUD

	End of Fiscal Year					
	1988	1989	1990	1991	1992	1993
Mortgages held by HUD	1,449	1,620	1,945	2,315	2,442	2,439
Properties in foreclosure	213	293	277	267	315	288
HUD-owned properties	62	44	55	116	170	184

Source: Data provided by HUD Office of Multifamily Housing Preservation and Property Disposition.

Note: At the end of FY 1993, the base of all HUD-insured mortgages was 15,081; this does not include the direct loan Section 202 and 312 programs.

Clearly, HUD has a large and increasing number of projects in foreclosure and has a large and increasing number of properties that it owns (“in inventory”). At the end of fiscal year (FY) 1993, HUD owned 184 projects (82 subsidized, 102 unsubsidized) with approximately 32,000 units and had in foreclosure another 288 projects with approximately 40,000 units.²⁰ Even though

¹⁹ The table is based on data obtained from the HUD Office of Multifamily Housing Preservation and Property Disposition. The author is responsible for the interpretation and for any mistakes in using the data.

²⁰ Mortgages that are delinquent in payments constitute a large and growing share of the HUD-held mortgages. According to data from the HUD Multifamily Accounting and Reporting System, 1,292 mortgages, or 53 percent of the 2,439 mortgages held at the end of FY 1993, were delinquent. This percentage has grown steadily since the end of FY 1988, when 33 percent of the 1,449 HUD-held mortgages were delinquent. At the end of FY 1993, 288 of these delinquent mortgages were in foreclosure, 123 were in workout, and 881 had no further action in process.

Table 5. Flow of HUD-Insured Properties through Foreclosure Process

	Fiscal Year					
	1989	1990	1991	1992	1993	1994
Properties in foreclosure at beginning of year	213	293	277	267	315	288
+ New properties entering foreclosure during year	100	29	41	129	70	105
" Properties taken to sale	20	45	51	81	97	103
= Properties in foreclosure at end of year	293	277	267	315	288	290

Source: Data supplied by HUD Office of Multifamily Housing Preservation and Property Disposition.

Note: Numbers of new properties entering foreclosure during year are inferred for fiscal years 1989 through 1993 (and do not include conveyances to HUD of properties under Section 202 or 312 or of Government National Mortgage Association coinsurance properties). Figures for 1994 are from HUD's budget accompanying their legislative proposal to Congress, adjusted to make the beginning-of-year number match the end of 1993.

Section 8 funds adequate to the statutory requirements for property disposition have been neither requested nor appropriated, HUD incurs substantial costs during its period of ownership, including covering the tenant rent subsidies that had been in place before foreclosure or HUD acquisition. On the basis of 31 projects sold in 1991 and 1992, HUD calculates that the average net claim to the FHA insurance fund was \$18,000 per unit (\$20,000 for unsubsidized, \$13,700 for subsidized), not counting holding costs. (Holding costs for these projects averaged \$6,200—ranging from \$2,600 for unsubsidized projects to \$12,700 for subsidized projects.)²¹

The federal budgetary quandary

Subsidy funds available do not begin to match the legislative requirements for preserving this housing as affordable, especially considering continuing foreclosures of additional properties. Through FY 1993, congressional funding for the requirements of Section 203 of the Housing and Community Development Act of 1978, as amended, amounts to a cumulative budget authority of \$1.8 billion, sufficient to cover only some 18,000 units, by HUD's estimates. HUD made projections of the

²¹ Data provided by the HUD Office of Multifamily Housing Preservation and Property Disposition.

requirements under current law, based on the current backlog of HUD-owned properties and properties in foreclosure and on estimates of continued foreclosures over the next five years. The basic scenario would clear out the backlog and keep current year to year after five years. According to these estimates, HUD would require \$5.4 billion in cumulative budget authority to treat 54,647 units over the next five years. This action would just catch up with the problem and does not represent the continuing steady-state subsidy requirements for dealing with current foreclosures and sales beyond five years.

The May 1993 GAO testimony highlighted another clear budget quandary, however. The necessary, but large, amounts of Section 8 funds needed for property disposition are considered part of the *discretionary* budget, which is subject to a ceiling, while the FHA insurance fund costs borne by HUD during its period of ownership are considered *mandatory* expenditures, which must be met with appropriations as needed and do not consume any of HUD's discretionary budget authority. The situation is as follows:

1. Current law requires HUD to preserve a prescribed number of units for 15 years at the point of HUD disposition. The expected mechanism for rental subsidy is Section 8 project-based rental assistance.
2. Section 8 budgets, as a discretionary item, are subject to the Budget Enforcement Act of 1990, which imposed ceilings on discretionary spending. Thus, HUD is forced to trade off requests for funding for property disposition against all other funding needs of the department. As a result, in previous years HUD has not requested and Congress has not appropriated anything close to any of the estimates of what it would take to clear out the backlog of HUD-owned and foreclosed properties.
3. Once the FHA insurance fund acquires a project, the project stops receiving whatever Section 8 or other forms of rental subsidy it may have been receiving, but tenants continue to pay the same rent as before. The insurance fund must pick up the full cost of operating and maintaining the project, including replacing any former Section 8 rental assistance. The funds required to cover these expenses and other costs of HUD's holding the property, however, are regarded as mandatory expenditures, using permanent, indefinite appropriations to the insurance fund.²²

²² Practically all of HUD's multifamily mortgages antedate credit reform. Thus, demands for insurance funds are drawn from the liquidating account of FHA's general insurance and special risk insurance fund.

4. This situation is exacerbated by the fact that the necessary Section 8 discretionary budget for property disposition must be appropriated in an amount sufficient to cover the entire budget authority for up to 15 years of Section 8 contracts, while the FHA insurance fund appropriations are drawn each year as needed but for as long as HUD owns the property.

In this situation, the FHA insurance fund must cover a series of costs, such as holding costs; expenses in excess of income (again, tenants keep paying whatever they were paying), including higher operating costs to repair and maintain undermaintained properties; interest on funds borrowed to pay off the lenders when the property defaulted; interest on any operating expense loans; and HUD administrative and management costs in maintaining and selling the inventory. (At disposition, the insurance fund again must cover the amount of the mortgage balance that must be written off because it is not covered by net sales proceeds.)

The May 1993 GAO testimony laid out these factors and pointed out that whichever funding source is used (the FHA general insurance fund or Section 8 rental assistance), the government pays for some or all of the shortfall between property revenues and expenses. The GAO “did not analyze whether it would be more cost effective to achieve the preservation of multifamily properties through selling them and using Section 8 subsidies or through HUD retaining the inventory and using the FHA General Insurance Fund to subsidize the properties” (U.S. General Accounting Office 1993, 9).

In preparation for congressional action on the property disposition problem, in the fall of 1993 HUD performed an analysis addressing the somewhat rhetorical question “Would HUD be better off holding or selling projects?” HUD analyzed a group of 31 projects (selected from a total of 132) sold in FY 1991 and 1992 (11 subsidized projects and 20 unsubsidized).²³ Among these properties, HUD estimated that the average costs of holding properties in HUD inventory for eventual disposition are essentially the same as the Section 8 costs would be, taking into account the opportunity cost of delaying sale proceeds and the

²³ While HUD did not indicate that the properties were selected at random or were regarded as typical of projects in the foreclosure and sale stream, the analysis at least illustrates that substantial costs are incurred during the period HUD owns these properties. It is not as though the budget drain starts when the Section 8 funds begin to flow after disposition.

cost of delaying the needed repairs until disposition.²⁴ HUD concluded from these 31 properties that the cost of providing Section 8 rental assistance would have been essentially equal to the total effective costs of HUD's holding and eventually selling this group of properties.

Whether this analysis holds across the whole inventory of HUD-owned properties, it makes the point that providing sufficient discretionary Section 8 funds would allow HUD to dispose of the properties for a cost to the federal budget that might not be appreciably different from the cost of HUD's owning them. Whatever the outcome of the current property disposition bills in Congress, obviously needed is a way for HUD to apply the funds now drawn from the FHA general insurance fund to provision of postdisposition Section 8 subsidies. It is hard to see the public purpose served by trying to preserve units in HUD-owned and foreclosed properties as affordable housing by means of a system that in effect forces HUD to own a growing number of these properties.

Current proposals on preservation requirements in multifamily property disposition

In November 1993, Congress had passed two bills to address the property disposition problem: S. 1299 and H.R. 3400.²⁵ Both bills stipulate the following:

²⁴ On the basis of these properties, HUD calculated that the average holding cost per unit was \$6,200 (\$2,600 for unsubsidized, \$12,700 for subsidized), since many properties were in poor repair, many tenants paid only 30 percent of their income even though HUD received no Section 8 payments, and the vacancy rate in the 31 projects sold averaged 41 percent—52 percent in subsidized projects and 35 percent in unsubsidized projects. HUD's computation of Section 8 costs was based on a utilization rate of 74 percent, 4 percent annual increases, and the assumption that HUD contributes 74 percent of the rent. (It is not clear from the HUD analysis provided the author exactly what assumptions were made about the extent of postdisposition Section 8 coverage in these 31 properties.) Under these assumptions, the average adjusted holding costs per unit per day for the 20 unsubsidized properties were \$4.96, compared with \$3.63 for Section 8; for the 11 subsidized projects the averages were \$13.41 per unit per day for adjusted average holding costs and \$14.80 for Section 8.

²⁵ Neither bill addresses the budget accounting system mentioned earlier under which HUD expenses in owning foreclosed properties are replenished by annual mandatory appropriations for the FHA general insurance fund, while Section 8 rental assistance must be appropriated in amounts sufficient to cover the full term of the Section 8 contracts and must vie with other demands for discretionary funds.

1. For *subsidized or formerly subsidized* projects, provide project-based Section 8 assistance to all units under a rental assistance contract at the time of foreclosure or acquisition. For up to 10 percent of the units of projects in soft markets, HUD could provide portable, tenant-based certificates or vouchers. For other units in subsidized projects, HUD would maintain affordability through rent restrictions.²⁶
2. For *unsubsidized* projects, project-based Section 8 assistance would be provided for all units under rental assistance contract at foreclosure or acquisition.²⁷

Both bills provide for upfront grants and loans for purchases by nonprofit organizations. However, the House bill adds two categories of requirements that practically restore the preservation requirements of the 1987 amendments:

1. *Rent restrictions.* For any subsidized or formerly subsidized project, preexisting very low income tenants will not pay rents more than 30 percent of income, and those that had been paying less than 30 percent of income at disposition are to be given a rent phase-in over three years. Except for unsubsidized projects for which the HUD secretary determines that rent restrictions would “unreasonably impede the disposition of the project,” rents in unsubsidized projects also are to be restricted so that very low income tenants pay no more than 30 percent of income for 15 years or until they are no longer very low income.
2. *Required assistance.* Where there is not sufficient habitable, affordable rental housing for very low income families and “to the extent that such assistance is available,” tenant-based *or* project-based Section 8 rental assistance is to be provided to very low income families “who are preexisting tenants and do not otherwise qualify for project-based assistance.” The available housing test notwithstanding, *project-based* assistance is to be provided for very low income families who are preexisting tenants “to the extent that such

²⁶ As an alternative, the bills allow HUD to provide project-based Section 8 assistance for fewer units if it provides eligible very low income families in the units with certificates or vouchers (portable, tenant-based subsidies) *and* requires that an equivalent number of units of unsubsidized projects in the same market area be made affordable to very low income persons. It is not at all clear how HUD would obtain such control over these other units in the market area.

²⁷ The Senate bill adds that tenants in units assisted with LMSA Section 8 would receive portable, tenant-based certificates or vouchers.

assistance is necessary to maintain the financial viability of the project.”

The primary difference between the two bills is that the Senate bill calls for a “hold harmless” provision of rental assistance to households already subsidized, while the House bill practically restates the objectives of the current statute. While the House bill would allow some unsubsidized projects to be sold without subsidy, it would require rent restrictions (without admitting that most of these will require Section 8 rental assistance) for essentially all the very low income tenants. It would provide a three-year phase-in for tenants currently paying less than 30 percent of income for rent—clearly calling for even more subsidy. Further, it is hard to imagine that many owners would be willing to declare that the financial viability of the project does not require assistance to the preexisting very low income tenants. Clearly the House bill, *if funded*, would add more units to the affordable housing stock than the Senate bill, but at a greater cost.

Among the other differences between the Senate and House bills, the Senate bill would impose civil money penalties against general partners and certain managing agents for failure to maintain properties in good condition and to provide acceptable management. The Senate bill’s laudable objective of management accountability would need much clearer definition, presumably through HUD regulations. The House bill would authorize up to 400 temporary employees to work on the administration of disposition without affecting staffing ceilings.²⁸ The House provision for additional staff to work on the disposition problem seems a practical recognition of the property disposition workload that HUD has on its hands. There is clearly a bulge in the work necessary to eliminate the backlog and reach a steady state of keeping up with ongoing foreclosures and disposition of HUD-owned properties.

HUD obviously should not be forced to own and manage properties when it lacks the Section 8 funds to legally transfer them to new owners. Either the statutory requirements must be met with the necessary appropriations of funds, or the statutory requirements should be relaxed to fit the available budget. Neither the Senate nor the House bill directly addressed the question of Section 8 budget authority. HUD developed estimates

²⁸ According to the May 1993 GAO testimony, HUD estimates that managing the inventory of HUD-owned properties involves about 128 full-time HUD staff.

of the requirements under current law and under the Senate bill, based on the following assumptions:

1. About 100 new properties a year will enter foreclosure.
2. The percentage of beginning-of-year foreclosure cases taken to foreclosure sale starts at 35 in FY 1994 and rises to 100 by FY 1998.
3. Half of the foreclosure sales result in third-party purchases.
4. The inventory of HUD-owned properties increases each year from HUD acquisitions at foreclosure sales and properties conveyed from Section 312 rehabilitation loan and Section 202 elderly projects.
5. The percentage of properties sold from the beginning-of-year HUD-owned inventory starts at 35 in FY 1994 and rises to 100 by FY 1998.

Under these assumptions, three budget scenarios were estimated: budget authority currently available, budget authority under the S. 1299 scenario, and budget authority required under the current statute. As shown in table 6, HUD's estimate of the budget requirements for the S. 1299 provisions—\$3.6 billion in budget authority—is double the cumulative budget authority (\$1.8 billion) available at the end of FY 1993. Also, beginning with the current backlog of properties in foreclosure and owned by HUD, under current law (Section 203 of the Housing and Community Development Act of 1978, as amended) HUD would require \$5.4 billion in cumulative budget authority to catch up in five years and be in a position to deal with year-to-year demands. The current \$1.8 billion in Section 8 budget authority would address only a small fraction of the properties and units already HUD-owned or expected to be acquired over this same five-year interval. These estimates do not address the period beyond FY 1998, by which time the assumption is that budget authority is available each year to allow HUD to take to sale all the properties entering foreclosure during the year and dispose of all the properties HUD has been forced to acquire in the previous year.

Alternatives for the property disposition dilemma

By any of the measures of housing need, there are millions of unassisted but needy households. In the larger perspective of

Table 6. Section 8 Budget Requirements for Property Disposition

Assisted Units	Current Law	Current Budget	HUD Assistance Proposal (S. 1299 Provisions)
Subsidized	36,734	12,297	33,318
Unsubsidized	17,913	5,741	9,134
Total	54,647	18,038	42,452
Budget authority (in billions)	\$5.4	\$1.8	\$3.6

Source: Data provided by HUD Office of Multifamily Housing Preservation and Property Disposition.

Note: Estimates were based on assumptions under which the backlog of foreclosures and HUD-owned properties would be worked off over a five-year period, fiscal years 1994 through 1998, leaving an annual requirement to deal with the current-year foreclosures and disposition of any HUD-owned properties.

making limited subsidy budgets reach as many targeted renters as possible, one can question the necessity of tying *new* subsidy funds to the HUD-insured properties in foreclosure or disposition. In an environment in which federal budgets do not support rental housing subsidies as an entitlement for all eligible households, directing additional subsidies to HUD-foreclosed and HUD-owned properties may not represent the best use of new subsidy dollars, either in terms of housing needs of unsubsidized households or in terms of property location.

The question of how best to use additional housing funds is at the intersection of two policy goals: (1) providing additional household assistance in a nonentitlement world and (2) community development. Nelson and Khadduri (1992) made the case that additional housing assistance should be concentrated on worst-case renter families with children as a matter of horizontal equity. Stegman (1992) and Cavanaugh (1992) criticized the focus on worst-case targeting because this approach gets very little political support and very little funding. Cavanaugh adds that such a strategy too often has been used as an excuse for the status quo—assuming a limit on assistance funds and arguing how they should best be spent. Cavanaugh also makes the point that the less targeted HOME program created by the National Affordable Housing Act of 1990 has been much better funded than the targeted direct assistance programs of Section 8 or public housing.

The second policy consideration is whether housing assistance funds should not only be used for the purpose of assisting eligible households, but should also be attached to projects for

community development. The basic argument for linking preservation of affordable housing to community development is that targeting benefits to individuals, especially under the worst-case scenarios, may be at the expense of the community. That is, properties losing subsidies may be a drag on the stabilization and revitalization of already troubled neighborhoods, while adding project-based subsidies or allowing some income mixing through higher income-eligibility limits may serve the purpose of neighborhood stabilization and revitalization. One problem with this argument is that propping up a single property does not necessarily save a neighborhood. Further, the public benefits of community development are diffuse and difficult to measure. Finally, it could be argued that these decisions are essentially local and therefore should be made by local government and funded through less targeted federal funds, particularly the HOME program. This solution would be preferable to developing rules at the federal level for deciding when Section 8 rental assistance should be used for community development. HUD has a big enough challenge in administering property disposition without having to deal with another layer of case-by-case issues.

Attaching subsidies to some properties in areas of high poverty or high minority concentration forces those receiving assistance to locate in or stay in those areas, rather than having the flexibility to move. One effect of the current law, if fully funded, could thus be to concentrate subsidized housing in distressed neighborhoods—directly counter to new HUD initiatives to use Section 8 rental assistance to help eligible households move out of high-poverty areas. Assuming the importance of reaching as many eligible households as possible with rental assistance, even if HUD requested and Congress actually approved the Section 8 budgets necessary to satisfy the 1987 amendments for property disposition, there are questions about the wisdom of targeting the subsidies this way, beyond those subsidies required to hold harmless currently subsidized tenants.

Finally, neither of the current bills deals with a lurking problem. What happens under any of the preservation scenarios when the project-based Section 8 contracts expire? Will these properties be in the same category as the Section 8 new construction and substantial rehabilitation projects facing the end of their Section 8 contracts? Will they face the same situation as the older assisted housing projects that faced the “expiring use” problem at the end of their contractual requirement to provide assisted housing? The preservation legislation addressing the expiring use problem placed a premium on the objective of conveying those properties to nonprofit owners, to the extent capable

organizations came forward. Conveying properties to nonprofit owners does not address the issue that maintaining affordability in these properties may require continuing subsidies for rental assistance, but it might increase the long-term prospects for maintaining a stock of affordable housing by placing these properties in the hands of organizations that have affordable housing and community benefits as their primary objectives. Both the current bills have provisions that would provide for upfront grants and loans for nonprofit purchasers, but neither bill assigns this mode of preservation a priority. Before moving to conclusions about the property disposition issue, a word is in order about intervention before the point of disposition.

Preventive measures

Everyone would probably be better off if ways were found to keep properties out of foreclosure. If properties are structurally sound and reasonably located to serve a low-income population, then keeping these properties going may be the most cost-effective way to provide affordable housing to low-income households.

Part of the problem is that HUD has not been able to adequately monitor the stock of HUD-insured multifamily properties. The HUD inspector general (IG) has repeatedly warned that HUD staff shortages, poor record-keeping, and inadequate computer systems make it impossible for the agency to monitor individual insured multifamily projects as it should. An IG report last year noted that while state agencies monitoring multifamily rental projects had caseloads of 16.5 and 12.5 projects per employee, HUD's regional caseload ranged from 28 projects per employee in Kansas City to 105 in Detroit (see HUD Office of the IG 1993a, 1993b, as reported in the *Washington Post* 1993).

Some suggestions for keeping properties out of foreclosure are

1. Improved monitoring systems to permit HUD to catch financial problems earlier (Coopers & Lybrand 1993).
2. Management improvements by owners to catch repair needs before they become serious and to enact allowable rent increases to cover expenses and build up project reserves.
3. Providing HUD more subsidy funds and flexibility to meet project capital repair costs, either through deferred-payment loans or by providing subsidies to cover the additional debt service required to amortize repair loans. The system now

seems to require that repair needs lead to financial problems before help is available. The results of the simulation model developed for HUD by Abt Associates (Wallace 1994) suggest that more liberal provision of capital improvement support could substantially reduce foreclosures, or at least postpone many of them for quite a while.

4. Relief on tax liability of phantom income (income received and used for repayment of mortgage principal but not counted for tax purposes as a deductible expense) for subsidized properties.
5. Better analysis of the ways all these factors interact (including HUD use of the simulation model).

Once properties have so many problems that the lender assigns the mortgage to HUD, some further, more aggressive interventions are in order:

1. HUD needs quicker access to the property while the property is still under its current owner/manager, so that interventions and possibly forced transfers can take place before the property has slid into serious disrepair and high vacancy rates.
2. HUD could provide support for tenant ownership (organization and training, equity buyout support like the preservation incentives, capital gains forgiveness) before an actual foreclosure, but the cost-effectiveness of such approaches relative to providing currently assisted tenants with tenant-based (portable) rental assistance needs to be evaluated.

Some projects are located in areas where none of these approaches can help in the absence of rental subsidies. A project may be in a neighborhood attractive only to low-income households, many of whom have difficulty paying even the low rents on the older properties, which often just cover the costs of operation and modest debt service requirements. In these cases, rent increases are not viable. Allowing some degradation in housing quality as maintenance and repairs are deferred may be the only means for the owner to continue operations, at least for a period. The question then becomes whether rescuing such properties and tenants through additional subsidies is the best use of limited rental subsidy funds.

Fixing the accounting problem

Clearly the federal budget's accounting conventions on mandatory and discretionary spending should be revised so that the true cost of HUD's holding properties is weighed against the cost of disposition with Section 8 subsidies. The HUD analysis cited here suggests that HUD may already spend as much on holding costs—with appropriations for these expenditures mandated for the FHA general insurance and special risk fund—as it would in the form of Section 8 assistance were these properties to be disposed of promptly. It makes no sense that HUD has been forced to retain in inventory half-tenanted properties that it could have conveyed at the same cost to new owners with all the Section 8 subsidies required by current law, simply because the holding and disposition costs are mandatory and the Section 8 subsidies for properties disposed of are discretionary and lack appropriations. At the time of writing, HUD and the Office of Management and Budget were evaluating options for gaining congressional approval of a method for treating as mandatory the funds required for Section 8 rental assistance in disposed properties.²⁹

Dealing with the problem of foreclosures and HUD-owned properties

Beyond fixing the accounting problem, the Senate version (S. 1299) of the property disposition legislation seems a sensible retrenchment from the ambitious but inadequately funded intentions of the 1987 amendments. The core provisions in both S. 1299 and H.R. 3400 would

1. Restrict HUD obligations to tenants already under assistance, rather than using the property disposition status to define additional eligibility. This approach makes sense both from the practical point of view that Congress had not funded its good intentions anyway and from the point of view that although currently assisted tenants should be held harmless, additional subsidy funds are not necessarily best tied to these properties.

²⁹ The HUD budget proposal for FY 1995 would remove Section 8 assistance for property disposition from the appropriation process by making funding mandatory rather than discretionary. FHA-insured properties sold at foreclosure to a third party or sold from the HUD-owned inventory would be provided Section 8 assistance without regard to funding limits in the appropriations legislation (*Housing and Development Reporter* 1994).

2. Allow HUD some flexibility in soft housing markets to provide portable, tenant-based assistance rather than tying it to the properties.

HUD should be allowed even more flexibility than it has requested from Congress, in particular in providing portable, tenant-based vouchers or certificates to tenants in areas of high poverty or high minority concentration or in properties that are in such bad shape that HUD shouldn't be saving them. Restoring projects in such areas needs to be part of a comprehensive community development plan and should not be undertaken simply because a failed FHA-insured project is located there.

The House bill adds provisions for "rent restrictions," most of which probably cannot be achieved without Section 8 rental assistance, and "required assistance" for most preexisting very low income tenants. Both these provisions would have the effect of expanding the requirements beyond the assistance needed to hold harmless previously assisted tenants. They expand the preservation objectives of the legislation without dealing with the question of the additional funds required or whether such funds are best spent on these projects.

Some helpful experience may be derived from the demonstration HUD is starting using state housing finance agencies (HFAs) to assist in the disposition and management of HUD-owned multi-family properties (*Housing and Development Reporter* 1993). HFAs in the running were those for Massachusetts, Illinois, New York, and the District of Columbia. Although HUD may offer some Section 8 assistance, it apparently is hoping that the HFAs will find other innovative techniques for property disposition and preserving affordable housing, presumably including tax credit allocations, tax abatement, and tax-exempt financing.³⁰

This article leads to the following recommendations:

1. Take steps to keep FHA-insured property out of foreclosure in the first place.
2. Fix the federal budget accounting rules so that HUD has some flexibility to spend on Section 8 instead of being stuck with paying holding costs.
3. For properties that are foreclosed or HUD-owned, apply subsidies only to hold-harmless tenants already subsidized

³⁰ HUD is prohibited from insuring loans to purchasers of HUD-owned properties.

(this is already a big step forward from the current situation).

4. Direct additional funds to “preservation” (really expansion) of assisted units in disposed properties only if the local community can show the action is part of a more comprehensive community development plan.
5. Don’t try to restore a hopeless project in an area that is already heavily poor or minority, unless the restoration is part of a community building plan of which this project is one element.
6. Use HOME funds for those projects that fit part of a community development plan.
7. Encourage maximum transfers to community-based organizations to minimize the future shock of expiring subsidy contracts.
8. Apply additional available subsidies to worst-case unassisted households.

Addendum

As this article was in final editing, quick action was taken by Congress and the administration on creating multifamily disposition legislation. On March 22, the House passed H.R. 4067, which merged many of the technical provisions of the earlier House and Senate bills (H.R. 3400 and S. 1299). It also essentially dropped the more stringent rent restriction provisions of the earlier House bill. This amended House bill was almost immediately passed by the Senate on March 25, sent to the White House, and signed into law (Public Law 103-233) by the president the week of April 11 as the Multifamily Property Disposition Reform Act of 1994. As enacted, the act *drops* the following features of the earlier bills:

1. The “rent restriction” and “required assistance” provisions of the earlier House bill, which would have maintained practically the same requirements as the then current law, either through rent restrictions imposed on owners even without subsidy assistance or through additional tenant-based or project-based Section 8 rental assistance

2. The Senate bill provisions for civil money penalties against general partners and managing agents
3. The earlier House bill provision for additional temporary HUD employees to administer disposition

It *adds* the following provisions:

1. Unassisted very low income tenants get a two-year rent freeze and are to be regarded as displaced for purposes of preferences of public housing and Section 8 rental assistance.
2. Upfront grants are allowed for the necessary cost of rehabilitation and other related development costs.
3. Transfers are allowed to public housing agencies or those authorized to own Section 202 elderly housing or Section 811 supportive housing (essentially nonprofit organizations).
4. Rebuilding is allowed to replace a project better demolished, if the new project can be shown to be less expensive than substantial rehabilitation or to have a longer life, if it promotes racial and low-income geographic deconcentration, and if the rebuilding is part of a local neighborhood revitalization plan approved by the local government.

The new act accomplishes some necessary reforms but leaves the critical HUD dilemma nearly intact. The act provides substantial relief from the requirements for additional subsidy under previous law and allows some potentially useful flexibility in permitting transfers to public housing agencies or nonprofit organizations—in allowing upfront grants and in permitting the assistance to be used to support neighborhood revitalization or replacement housing that better meets public policy goals of racial and low-income deconcentration. It still does not address HUD's dilemma if the necessary budget authority in the discretionary Section 8 budget is not provided. As noted in the body of the article, HUD's FY 1995 budget proposal calls for defining the Section 8 funds required for disposition as mandatory expenditures, rather than counting them against the discretionary HUD budget, so that they would be treated the same as the funds HUD now uses to acquire and hold or sell these properties.

Author

James E. Wallace is a Vice President and Principal Associate with Abt Associates, Inc.

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