

153
HUD MULTIFAMILY HOUSING CRISIS

Y 4. B 22/3: S. HRG. 103-263

HUD Multifamily Housing Crisis, S.H... RING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

ON

PROBLEMS PLAGUING THE FEDERAL HOUSING ADMINISTRATION'S
MULTIFAMILY HOUSING INSURANCE PROGRAM RESULTING FROM
THE INCREASING NUMBER OF FORMERLY INSURED MORTGAGES
THAT HAVE COME INTO INVENTORY AFTER DEFAULT, AND MORT-
GAGES THAT ARE AT RISK OF DEFAULT DUE TO THE POOR DESIGN
OF COINSURANCE AND FAULTY UNDERWRITING. OTHER PROBABLE
CAUSES ARE LINKED TO THE ABSENCE OF SUFFICIENT MONITORING,
LACK OF ADEQUATE STAFF, THE DOWNTURN IN REGIONAL RENTAL
MARKETS AND THE IMPACT OF TAX REFORM

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JUNE 22, 1993
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Printed for the use of the Committee on Banking, Housing, and Urban Affairs



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HUD MULTIFAMILY HOUSING CRISIS

TUESDAY, JUNE 22, 1993

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:05 a.m., in room 538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes presiding.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES [Presiding]. The committee will come to order. We're very pleased to welcome Secretary Cisneros to this hearing on issues in multifamily housing.

Today is the fourth in a series of oversight hearings by the Housing Subcommittee looking into various problems confronting the new administration at HUD as it takes over its responsibilities.

We feel that it is important to try to get a realistic view of what the landscape looks like.

In the first three hearings in the series, we reviewed overall management difficulties at HUD. We looked at the progress made by the Department in implementing the 1992 changes to the Home Investment Partnership program, and we examined solutions to the problems of distressed public housing.

This fourth hearing is intended to focus on the problems plaguing the Federal Housing Administration's multifamily housing insurance program.

This hearing may, in fact, be the most important of the series, because the scale of the problem appears to be much larger, and the solutions seem to be more difficult.

Mr. Secretary, it's been our purpose in each of these hearings not to look at the negatives, but to build a hearing record that will be helpful in solving what are, unfortunately, longstanding problems. Our intent is to search for helpful solutions.

The problems facing HUD's multifamily programs are of some duration. Multifamily housing markets have been particularly troubled as a result of the over-building in the early 1980's, often utilizing very lax provisions in the Tax Code.

Over these last few years, Congress has passed several major housing bills, trying to come to grips with multifamily housing issues.

In 1987, and then again in 1990, Congress passed legislation addressing the preservation of affordable housing threatened by the pre-payment of the HUD assisted mortgages. The 1989 HUD Re-

form Act dealt with the fallout from the coinsurance debacle of the late 1980's and other scandals at HUD.

As we well know, during the Pierce administration, we experienced a series of extraordinary difficulties at HUD, and, in fact, some of those matters are now being addressed in the courts.

The 1992 Housing bill created a new process for assessing the capital needs of physically and financially distressed HUD insured multifamily projects. And the 1992 Act created a risk-sharing demonstration program that may provide some promise of an effective multifamily housing finance mechanism.

I think it's fair to say that we knew, throughout this period, that the multifamily program needed much work. However, I don't think we fully realized, as we now do from recent articles and audits, the magnitude of this problem. In fact, the weekend papers contain lengthy stories led by a long story in the New York Times. This story was enough to ruin my Sunday morning breakfast:

Billions in losses seen in mortgages insured by HUD, taxpayers to bear cost, troubles are tied to downturn in real estate market and neglectful management.

That's the heading.

HUD has now set its loss reserves for its insurance in force at \$11.9 billion. We still don't have complete information. In fact, this New York Times article is based on a survey done by Coopers & Lybrand, but that's only a survey. As I understand it, HUD still lacks the database capacity to aggregate the performance and condition of the entire portfolio.

We want to explore today the rapid growth in the HUD-owned inventory—the fact that HUD has begun foreclosure proceedings on an additional 43,500 units. That growing inventory raises questions about HUD's ability to maintain the properties in good condition, and also the costs associated with the requirement to subsidize these units upon sale.

In 1987, Congress enacted a law which provided that to sell multifamily units that were either formerly subsidized or which are currently occupied by low-income tenants, HUD must provide a Section 8 rental subsidy upon disposition. Although no administration has yet requested sufficient funds to comply with this requirement, it ought to be underscored that Congress had a very worthwhile purpose in mind in enacting the 1987 disposition law: The law was actually enacted as a means to protect the existing low-income tenants of these buildings and to preserve desperately needed affordable housing for low-income families.

But the 1987 law does raise questions in terms of being able to proceed now, when the resources are just not there to fully comply with the requirement of the 1987 statute.

In closing, I think it's important to recognize that the question of property disposition, which often tends to be the focus of attention, is really a question about the end of a long, troubling chain of events.

Although the HUD Inspector General has identified major problems all along the continuum, from the underwriting of the mortgages to the disposition of the defaulted property, obviously better management, early intervention, and the prudent workout of troubled loans offer some possibilities for addressing this problem.

I particularly want to underscore this morning that the Secretary, himself, was anxious to come and testify at this hearing. I think his presence is another reflection of the very forthright manner in which he is addressing the difficult problems confronting him at HUD, and we look forward to the progress you can make on these issues, Mr. Secretary.

I welcome you and Assistant Secretary Retsinas to the committee this morning.

I understand, at some point, that the hearing will be interrupted because the President wishes to talk to the Secretary. When that call comes in, we'll take a brief recess and we will excuse the Secretary. We may in fact continue with Mr. Retsinas at the table, in order for the Secretary to take that call.

Senator D'Amato.

OPENING STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. First of all, Mr. Chairman, let me commend you, Senator Sarbanes, for calling this hearing. I look forward to hearing the Secretary's testimony on how we can ensure the continued availability of low- and moderate-multifamily housing while securing the financial stability of the FHA Administration.

The need for affordable housing is undeniable. In order for this opportunity to continue, the FHA program must be able to fulfill its mission while remaining fiscally sound.

HUD owns an inventory of 187 multifamily properties with 31,500 units, and this inventory is growing rapidly. HUD's ownership of this inventory incurs some significant costs. Holding costs for the year 1992 alone for these properties totalled \$248 million, or to put it another way, \$8,267 per unit.

So I think that underscores the necessity, as you pointed out, Senator Sarbanes, of a disposition plan that will balance the need for affordable housing that's far overdue, and Congress must work together to develop a plan that will provide the needed flexibility and innovation to dispose of the current inventory while addressing our community housing needs.

I'm going to ask that the balance of my statement be placed in the record as if read in its entirety, so we'll have an opportunity to hear the Secretary.

Senator SARBANES. Thank you very much, Senator D'Amato.

Senator Bond regrets he cannot be here today. He very much wanted to be, and I have a statement of his which I'll include for the record.

Senator SARBANES. We are very pleased that the Chairman of the Full Committee has joined us here this morning for this hearing.

Senator Riegle.

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

Senator RIEGLE. Thank you very much, Senator Sarbanes. Let me commend for calling this timely hearing and for the subcommittee's ongoing effort to look at the massive internal management problems at the Department of Housing and Urban Development.

Today, the subcommittee will examine the systemic problems in the multifamily housing programs at HUD. And I want to thank

Secretary Cisneros for coming. This is the fifth time that he will have testified before this committee directly this year. I appreciate his take-charge attitude and his performance at the Department.

I also want to welcome Jim Logue, who is the Executive Director of the State Housing Finance Agency in Michigan.

As we have now recognized, and as the Secretary, and you, Mr. Chairman, have recognized, there is no problem facing HUD of greater importance than the massive losses that are likely to result from the sharp increase in apartment building owners who default on their Government-insured mortgages.

You have indicated that this issue is your "highest priority." This problem is also of the highest priority to me and to this committee. I'm encouraged by the fact that the administration is about to announce a detailed program to deal directly with it.

The Department's multifamily housing programs and their management deficiencies have been a very longstanding concern. It was 4 years ago, in August 1989, that this committee held hearings on the effects of mismanagement, fraud, abuse, and the economic slump in the Southwest on the FHA programs.

In order to respond to these problems, we created, in November 1989, a special ad hoc investigative subcommittee, headed by Senator Graham of Florida, and also Senator Mack, who was the Ranking Minority Member to systematically dig into these problems. Among other things, the subcommittee's findings at that time highlighted some of the very multifamily problems that we are here addressing today.

Also in 1989, Congress passed the HUD Reform Act which instituted a number of management reforms, including the establishment of a chief financial officer, the creation of a comptroller within FHA, and the requirement of annual audited financial statements for FHA, so we could understand exactly what the financial footings were.

The final audit report for fiscal 1992 just became available and is before us today. Despite the many problems confronting the Federal multifamily housing finance system, it is essential to providing affordable housing across the country.

Last year, in the Housing and Community Development Act, we directed HUD to undertake two multifamily demonstration programs, which Senator Sarbanes has referred to, to pursue risk-sharing arrangements with State housing finance agencies and the Government-sponsored enterprises, namely, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

As a result of management reforms and audit requirements now in place, we have data that illustrates the true magnitude of the problem. And we must take whatever additional steps are necessary to clean up these problems and to make these programs work properly and on a sound financial basis.

So, Secretary Cisneros, I appreciate that you are addressing these issues head on, as you told us you would when you took this job. You have inherited a great challenge in many areas. This committee will work with you to make whatever changes in the law are needed.

If you find that you need additional resources to get on top of these problems and to stop longstanding practices that are not

working as intended or they should, you tell us about that, and we will go to bat. I'm confident that on a bipartisan basis we can get what we need to deal with it, because these are issues that have to be addressed.

I think by working together in that fashion, we can solve any problems that are there, and also provide affordable housing to people across our country.

Senator SARBANES. Thank you very much, Chairman Riegle.
Senator Mack.

OPENING COMMENT BY SENATOR CONNIE MACK

Senator MACK. Thank you, Mr. Chairman.

I just want to welcome the Secretary, and look forward to his testimony. And say how fortunate we are that we have now had two Secretaries that have shown a real desire to work with the Congress and with this committee in trying to not only uncover, but to solve the problems that face our nation with respect to affordable housing. So I look forward to your testimony and I look forward to working with you on this problem.

Senator SARBANES. Thank you very much.
Senator Dodd.

OPENING STATEMENT BY SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman.

Let me join in welcoming Secretary Cisneros. You couldn't be here at a more important moment, obviously, in talking about this particular issue.

And I'm sure the Chairman has made note of it already, but there is a substantial need for multifamily housing. Currently, about 60 percent of families at the poverty level pay at least half of their income on rent.

Any hopes that these people have of moving out of rental housing and into homeownership, or putting money aside for education, become extremely difficult. Consequently, we need to expand the multifamily housing market. Given that need it's unfortunate that the Federal multifamily programs are facing huge losses. As Chairman Riegle has pointed out, and others, we've really got to work together on this.

Historically, as I know the Secretary and the Chairman know, housing issues were never partisan issues, never. In fact, the great champions of housing arguably were more conservative Members of this body over the years.

Senator SARBANES. Senator Taft, for one.

Senator DODD. Absolutely. And others who really championed the cause of decent, affordable shelter for people. My sincere hope is that we can get back to that.

There may be a temptation here, with the \$12 billion we're talking about, to do some fingerpointing. You inherited a problem Mr. Secretary and this Senator has no intention of revisiting how we got into this situation.

My hope is that in a bipartisan way we can really help resolve the problem and put forward an intelligent, thoughtful, multifamily housing program in this country, so that people do have a chance

to escape the burdens of poverty. Affordable housing is an essential part of the equation.

When 50 percent of your income is going to pay for housing, you're never going to make it, you're never going to get out of poverty. So it's critically important to really work together on these issues.

Again, I'm pleased that the Secretary is here, and I apologize to the Chairman for taking up so much time. But thank you.

Senator SARBANES. No, it was a very helpful statement.

Senator Bennett.

OPENING COMMENT BY SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

I'm not a Member of the subcommittee but I appreciate the opportunity to sit in, and will simply endorse what Senator Dodd had to say. This is a problem we all need to work together on, and I'm here to learn.

Thank you.

Senator SARBANES. We are very happy to have you with us here this morning.

Mr. Secretary, we'd be happy to hear from you.

STATEMENT OF HENRY G. CISNEROS, SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY: NICOLAS RETSINAS, ASSISTANT SECRETARY FOR HOUSING/FEDERAL HOUSING COMMISSIONER

Secretary CISNEROS. Thank you very much, Senator.

Mr. Chairman and Members of the committee, let me begin, if I may, by departing momentarily from my remarks to say two things.

The first is to say thank you to you, Mr. Chairman, to Chairman Riegle of the Banking Committee and to the other Members of the committee who, by their previous work, have made it possible for us to identify this problem.

The stories that appeared in the newspapers over the weekend are a result of information which was required because of the work of this committee. In other words, the committee Members, in their correct oversight responsibilities, have set in motion procedures, such as the Reform Act and others, which resulted in the audits and, for the first time, identified the magnitude of the problem by requiring the Department to collect the data that had never been put together in quite that way.

I think it's important to acknowledge that oversight role has been played and, as a result, the difficulty has been set out in this coherent way. And I just want to thank the Members of the committee for putting us in a position to get the job done from here.

Second, I appreciate the bipartisan tone of the comments by the Senators because I think you have discerned—as you say, I've been here five times—that my task is not to look backward or place blame or anything of that nature.

My experience over the years has been that any time one spends looking backward is time spent and energy diverted from the task that requires all of our attention, and that is to go forward from

here. So I appreciate that very much, and I hope that's the spirit you'll find in our work.

Finally, let me say, in these preliminary remarks, that the gentleman seated to my left is going to be the key to solving much of this. Nick Retsinas is a real talent, a real find, and I think we'll see, over the years, is a star in this administration. His work in the State of Rhode Island not only made him an expert in housing management issues, but—and this is one of the reasons we brought him to HUD—he gets credit nationally for having brought Rhode Island through the thrift difficulties of several years ago. The Governor attributes to him, personally, the workout role.

And we'll be looking to him for the same kind of initiative. It's already evident that he has a sense for the best way to work our way through this.

As Secretary, I'll be working with him, listening carefully, making my own judgments, but when I can, backing him to the hilt to do what needs to be done. And I say that because I want you to have the confidence in this person, and as we go through today's discussion, as he talks through some of the details of this, I think you'll be able to see that he's got a handle on much of what we're discussing.

I'm going to move through this very quickly because, as you said, I did receive word in advance that the President needed to talk to me before a major meeting that he has at 10:45 a.m. He suggested that I should talk to him sometime between 10:30 a.m. and 10:45 a.m., so I'm going to be moving through what otherwise would be about 15 minutes worth of testimony, to get it on the table here, and then you will excuse me as I step aside for a few minutes.

Let me just say that this problem is complex and has many dimensions—the issue of management and disposition of HUD's multifamily inventory.

When we prepared for today's hearing, it was about disposition of inventory. As a result of the events of the last few days, we want to talk, as well, about the management of that which we have insurance behind.

In some sense, we're not only talking about the car that's gone over the cliff already, which needs attention because there are people who have been hurt, but also the cars that are rushing toward the cliff. We need to set some alarms and find ways to slow down that acceleration, which would be very serious for the entire country.

On one level, it's an operational problem. There's been phenomenal growth in the numbers of properties that are owned—or going to be owned on the present trajectory—by the Department.

The Department also holds increasing numbers of formerly insured mortgages that have come into our inventory after default. Still other insured mortgages are at risk of default. The capacity of the Department to manage all this—to sell properties, to mitigate losses once defaults occur, and to avert defaults—is what is at question.

On another level, it is a money issue. Preserving the affordability of foreclosed and HUD-owned properties will be costly, whether or not we loosen legislative restrictions. Insurance claims, as Sunday's New York Times article concluded, could run into the billions.

On still another level, it is an affordable housing issue. Many of the properties were designed to serve—and do serve—low- and moderate-income families. In many jurisdictions, this housing is a resource that must be preserved. It is simply not an option to put that number of people on the street, because we refuse to keep that stock affordable.

And finally, it's a neighborhood issue. I won't dwell on that, except to say that when we allow properties to decline, we contribute to the deterioration of neighborhoods as we leave huge buildings unattended and deteriorating so that vagrants and drug dealers and so forth can use them.

As I mentioned a moment ago, you know, if anyone in America knows, the problem is not new. You've held hearings since the 1980's, and outlined the basic causes of the dilemma. We appreciate the oversight role that has brought this to our attention.

What is new is the extent of the problem. Congressional mandates for FHA audits have appropriately required the Department to upgrade our information systems, and now we can acknowledge the depth and severity of the problem.

My testimony this morning is intended to do three things: To outline the nature and scope of the problem, to explain how and why we got here, and to outline an aggressive action plan.

Mr. Chairman, you and other Members of this committee can be assured that resolving this crisis has my personal highest priority and, as I said earlier, Nic Retsinas will be the key person on whom I rely for advice and direction and management on this issue.

Resolving this problem will require a high level of political will and commitment within the administration and the Congress. It will require legislative relief this year. We will be before you in another month or so with what we're calling the Housing Act of 1993, the core of which is the legislative relief that will be required to deal with this question. Let me first state the problem.

HUD's multifamily problem has three main components. There's the phenomenal growth in the numbers of properties that are owned—or about to be owned—by the Department. There's the fact that the Department holds increasing numbers of formerly-insured mortgages that have been assigned after default. And finally, there is a substantial portion of other insured mortgages are at risk of default.

This is, Senator, what you referred to as, and what the survey identified as, the risk potential.

The first chart that we have here spells out the relative size of each part of the problem. As you can see, the inventories of HUD-assigned mortgages and HUD-owned properties are large and growing. At the end of fiscal year 1992, out of nearly 18,000 active FHA mortgages and projects, 14 percent were HUD-assigned and 1 percent were HUD-owned.

Let me explain each part of the problem in greater detail, both in terms of size and origin.

First, the properties that HUD owns or is about to own. The chart before you shows the growth in the HUD-owned inventory, which totalled 170 projects—about 29,000 units—at the end of fiscal year 1992. This is an increase, by more than a 100, of projects owned by HUD at the end of fiscal year 1988.

The arithmetic reflects a simple truth. HUD has acquired projects much more rapidly than it has been able to sell them. HUD acquired 72 projects in fiscal year 1991 and sold 11; it acquired 67 in fiscal year 1992 and sold 27.

How this happened is directly attributable to two factors: Restrictive statutes governing property disposition, which we must talk to you about, and the failure to request sufficient funding to carry out the legislative mandate. Let me be specific.

The Housing and Development Act of 1987 directs HUD to sell projects at foreclosure sale and from inventory in a manner that preserves them as affordable housing. That is a laudable public policy objective.

The legislation requires that expensive subsidies—15-year project-based rental assistance—be used to achieve the affordability objective.

Previous administrations opposed these legislative restrictions and refused to ask for the level of funding needed to carry them out. Thus, funding to assist the sale of properties has not been realistic and has not kept pace with inventory growth.

For example, HUD received a total of \$96 million in section 8 budget authority for property disposition in fiscal year 1993—enough to fund 15-year section 8 contracts for approximately only 1,100 units.

The result is disposition gridlock. Properties owned by HUD simply cannot be sold expeditiously because they do not have the section 8 attached to them, and thus sit in the inventory for an average of 3½ years, during which time the landlords are not maintaining them or worse, even walking away from projects. The projects are declining and the residents suffer.

HUD is not organized to manage and to rehabilitate projects. Time and again, Inspector General reports have found that HUD lacks adequate staff to manage properties and prepare them for sale.

HUD therefore incurs substantial holding costs to maintain projects in the inventory. It costs the Government about \$14 per unit per day to maintain formerly subsidized properties. A recent Government Accounting Office study of the multifamily property disposition inventory found that HUD incurred holding costs of about \$254 million in fiscal year 1992. This figure represents the difference between property revenue—largely from rents—and expenses for operating, such as maintenance, taxes, utilities and interest on borrowed funds. We simply are not a good landlord.

In addition, GAO adds \$5.8 million annually for the salaries of the HUD staff managing the inventory. These holding costs, paid out of the FHA General Insurance Fund, essentially substitute for directly appropriated subsidies which would be required by law to maintain the low-income tenancy of the projects if they were sold.

Mr. Chairman, if I may pause at this moment and ask Nic to continue, I want to excuse myself for a few moments to call the President, cover the matter which he wants to discuss before his commitment, and then I will be back to continue if that is an appropriate way to deal with it.

Senator SARBANES. Very good, Mr. Secretary.

Senator RIEGLE. Mr. Chairman, at this point, would you mind if I just pose a question? I want to understand one thing, as a predicate for the continuation of Mr. Retsinas' comments.

Senator SARBANES. Well, let's excuse the Secretary.

Senator RIEGLE. Yes, right.

Senator SARBANES. So he can get on with his call, and certainly.

Senator RIEGLE. Thank you.

Just so we understand what's going on here, we have these vacant units out there right now, and we don't have the program support to put people in them. The number of vacant units is rising. Is that correct?

Mr. RETSINAS. The number of vacant units is rising. However, many of these properties are occupied, which is a sad fact because the properties are deteriorating while they're occupied.

Senator RIEGLE. But in terms of the number of situations where you've actually got vacant units that have been taken over and that are not being properly cared for, I mean, they're sort of deteriorating, how many are in that category? How many individual units of that kind would there be across the country?

Mr. RETSINAS. That's in terms of the HUD-held inventory?

Senator RIEGLE. Yes.

Mr. RETSINAS. Less than 50 percent.

Senator RIEGLE. What does that add up to? What's the number?

Mr. RETSINAS. Of the HUD-held subsidized inventory, approximately 5,000 vacant units.

Senator RIEGLE. Five thousand vacant units?

Mr. RETSINAS. Approximately.

Senator RIEGLE. But just to again make this clear, so we've got 5,000 vacant units out there in whatever state of repair or disrepair that presumably are needed by people who are out in the country who want to get out of doorways and out from under bridges, and they want to get into a housing situation.

So we actually now possess these vacant units, and we've got the people that need to be in the units, but we're stymied right now getting the people into the units. Is that what you're telling us?

Mr. RETSINAS. Because we do not have the resources, correct. Yes, that is right, Senator.

Senator RIEGLE. Let's go ahead.

Senator SARBANES. All right, Mr. Retsinas, if you'd carry on, please.

STATEMENT OF ASSISTANT SECRETARY NICOLAS RETSINAS

Mr. RETSINAS. Thank you, Senator, and good morning to all of you.

As the Secretary started to indicate, he was walking through the various categories of property.

The first category he covered was the HUD-owned inventory—that is properties actually acquired through foreclosure by the Department.

The second, and larger category—

Senator SARBANES. That's 29,000 units?

Mr. RETSINAS. Correct.

Senator SARBANES. Of which 5,000 are vacant?

Mr. RETSINAS. Approximately.

The second category, which is a much larger category on the chart, are the HUD-held mortgages. These are mortgages where there have been defaults and the mortgages have been assigned to the FHA.

I want to continue with his testimony, if I may.

The second part of HUD's multifamily crisis is the HUD-held, as distinguished from the HUD-owned, inventory.

As I stated before, the inventory of HUD-assigned mortgages is large and growing. At the end of fiscal year 1992, HUD held nearly 2500 mortgages, an increase of about a thousand mortgages over the number held in 1988.

With the growing number of HUD-held mortgages, as you can see on the chart, the share of delinquent mortgages also increased. At the end of fiscal year 1992, more than half of the HUD-assigned mortgages were delinquent mortgages, compared to 33 percent in fiscal year 1988. A total of 266 mortgages, or about 41,000 units, were in foreclosure.

In recent years, HUD has sold to third parties about half of the projects taken to foreclosure sale and acquired the remainder. A number of factors led to the growth of this portion of the inventory.

The multifamily stock was impacted by the adverse economic and tax consequences of the 1980's housing recession and the 1986 Tax Reform Act. HUD, like many other lenders, was not immune from the downturn in the real estate economy.

Significant downturns affected regional economies, putting severe pressure on local housing markets. In this environment, loose lending practices and underwriting mistakes, through the coinsurance program, exacerbated a very difficult market.

Tax benefits lost to subsidized projects (and multifamily housing in general) led to financial distress in some cases and to disinvestment in others. In addition, the projects were aging and showing the economic and physical wear and tear of years of use. These projects lacked the financial means or mechanisms to refurbish the physical plant.

Problem three, which may not attract the attention, but in many ways is the more important problem, is the insured inventory, and in fact was the subject of the newspaper article to which the Senator has referred.

The third part of our multifamily crisis is the at-risk FHA-insured inventory. Currently, FHA has \$43 billion of multifamily insurance-in-force, that is, outstanding insurance. According to the audit, fully 27 percent of that amount, almost \$12 billion, is at risk of default.

The same things that led to the default in inventory have led to this at-risk insured inventory. The economic downturn affected properties in the FHA portfolio (as well as the private market); flawed program design and implementation (for example, coinsurance) led to the problem loans; and faulty underwriting by HUD led to bad loans insured by FHA.

That's the outline of the problem. What we need to focus our attention to, and what this hearing will help us do, is focus on what we do now. And I'd like to walk through some of those steps.

It bears stressing that this problem has evolved over many years. While the newspaper articles may have been recent, the problem,

as you know, has been emerging over time. Thus, it will take a concerted effort, additional resources, and many years to resolve it.

For one aspect of the problem, the property disposition problem, we need legislative action this year. In many respects, as many of you have pointed out in your opening statements, the current law is rigid and unnecessarily adds to the cost of the process.

The legislation the Secretary will be proposing will increase our ability to deal with the subsidized and unsubsidized stock in a reasonable and cost-effective manner. Let me give you some of the principles or the outline, if I could, of that legislation.

We will propose to revise the subsidy treatment for a small portion of the subsidized and formerly subsidized projects to provide some flexibility which would allow us to create a better income mix.

Second, we intend to protect units and tenants receiving project-based rental assistance in unsubsidized or formerly unsubsidized projects by providing 5-year, project-based renewable section 8 assistance, focusing on the tenants.

This approach will ensure that such tenants will not be adversely affected by sale of the project, and will allow HUD to retain the ability to sell projects on the private market for market rate mixed rental use.

Third, we will also be proposing a new approach that recognizes the reality of the current mandatory nature of the affordable housing provisions for those units where a mandatory subsidy is necessary to preserve affordability for previously subsidized units.

As you referred to before, the legislation clearly states that we have a requirement to preserve that affordability, and we intend to propose a way to live up to that requirement.

Fourth, we intend to request greater flexibility for the department to respond to individualized conditions, such as the existence of soft markets, the need for other forms of subsidy, or the potential for low-income uses which are non-rental, such as low-income homeownership, or a homeless shelter, for example.

And last, we intend to propose to reengage state and local governments by consulting with them earlier in the process and involving them in the development of disposition strategies; not at the end of that strategy, but early on in the formulation of that strategy.

While the solutions required for HUD's property disposition problem are largely legislative, we must also address the need for increased financial resources. To that end, we have already begun talks with the GSE's, State and local governments, and financial advisers, on ways to access capital to finance the disposition of our inventory.

HUD, for example, will enter into innovative risk-sharing arrangements with State and local housing finance agencies. We are also investigating refinancing of developments that will improve the financial condition of many of our properties.

As you know, there has been a change in capital markets and we believe the Department should be in a position to take advantage of that change to strengthen its portfolio.

Addressing the property disposition issue is critical, and an especially challenging task in an environment of continually declining

resources; but we must also address the issue of HUD-held mortgages and those about to default.

These will require two types of largely administrative actions. Those to mitigate losses, once defaults occur, and those to prevent defaults.

Some of these actions we have recently implemented, others we are currently pursuing. I want to describe these actions for you now. We have a chart that outlines them, and let me walk through them briefly.

First, since the audit, we have established a Loss Mitigation Committee. The Loss Mitigation Committee is charged with formulating and implementing a work plan to mitigate losses.

Second, we're instituting an "early warning system," which includes automating the collection and analysis of project financial statements, so we can rapidly identify problem trends. It is clear that it is possible to get advance notice, that there are ways to analyze and look at financial statements that will give us an indicator that things are starting to go wrong, and that we need to intervene.

Third, we have already initiated field staff training to expand skill levels. Later this month, we will be inviting field staff from around the country to talk about some of these changes, and others that I'll be going over.

Fourth, we are in the process of drafting aggressive, yet flexible, workout strategies. As the Secretary indicated before, we are not good landlords. And we will need to find ways to keep these mortgages whole and to keep the properties in the hands of private owners and give them appropriate incentives to manage those properties appropriately and to meet their obligations.

Next, we will pursue delegation of servicing responsibility to others, such as housing finance agencies, to reduce servicing ratios and compensate for continuing staff reductions.

We intend to implement the legislative initiative that was enacted several years ago to create a demonstration disposition program by identifying State and local agencies with clear management capacity, and have them play a role in the disposition and management of our portfolio. We are currently using loan servicing contracts to manage the formerly coinsured loan portfolio.

Sixth, to take advantage of the market, we are pursuing streamlined refinancing strategies. This is a historic, low-interest environment. We need to find a way to take advantage of that environment to strengthen the cash flow and financial condition of our portfolio.

Seventh, we are in the process of revising our flexible subsidy regulations to make this program more attractive to owners and less cumbersome.

Finally, and perhaps most importantly, we are currently conducting training for certification of HUD appraisers to better ascertain property values, not just to help us design project workouts, but perhaps more importantly, to help us ensure that the loans we make tomorrow will not be similarly at risk.

However, even with these enhancements to our loan servicing and foreclosure prevention efforts, I must caution you that we do

not believe that they alone will solve the problem of managing and disposing of our portfolio. What happens if we do nothing?

If we do nothing, the problem can only get worse, and I can guarantee you, it will get worse. While we will work to prevent foreclosures and an increased disposition problem through improved loan management and servicing, we already face an enormous property disposition problem with a long and difficult history.

We would like to discuss our current course of action and what happens if we do nothing to change our disposition actions.

On our current course, the inventory will continue to increase as the number of foreclosures far exceeds our ability to sell the properties. HUD will be required to own, manage, and preserve the inventory as a source of affordable rental housing, a task which everyone, including ourselves, agrees we are not equipped to handle efficiently.

It's important to note that the cost of subsidizing the inventory will continue as a mandatory expenditure under the FHA Fund. Whether HUD holds the inventory and continues to use the FHA as an indirect subsidy mechanism, or returns the stock to the private sector and uses a more direct subsidy mechanism, such as section 8, the Federal Government will, in either case, bear the costs.

Whether we choose to highlight the cost under the section 8 program, or disguise it as FHA spending, we are already spending the money. It's already costing us money. Spending is not the issue here. The issue is discerning what are the appropriate means for spending to preserve and protect the stock, and whether HUD or the private sector is better equipped to repair, manage, and own the properties.

While savings can be achieved by fine-tuning current requirements, the spending decisions, in large measure, have been made. The commitment by Congress and past administrations to preserve the stock, or at the very least, protect low-income, subsidy eligible tenants, have built housing subsidy expenditures into the fabric of the Federal budget.

To do nothing is to decide that the Federal Government will continue to spend subsidy dollars through the FHA Fund on an inventory of projects it will own and manage. While this decision may appeal to some, because the required subsidies do not have to be specifically appropriated, it has a significant hidden cost that may spell potential disaster for affected tenants, projects, and communities.

With HUD ill-equipped to own and operate large numbers of distressed properties, the rapidly growing inventory will continue to deteriorate, blighting the surrounding communities and hampering local revitalization efforts.

The GAO, in recent testimony before the House Subcommittee on Housing and Community Development, properly framed the issues now facing us. In describing the current management and disposition process, they said:

" . . . the shortfall between property revenue and property expenses will be paid by the Federal Government. This will occur whether or not the properties are sold and managed by the private sector or kept in inventory and managed by HUD. If the properties are sold, currently the shortfall is paid for with section 8 rental subsidy which is funded by appropriations with HUD's discretionary budget authority. If the properties remain in inventory [and are not sold], the shortfall is funded

through the FHA's General Insurance Fund. The real questions, Mr. Chairman, are (1) how the Congress wants to fund the preservation of its low-income housing, and (2) who the Congress wants to manage it. Current budget considerations result in a bias toward funding preservation through the FHA's General Insurance Fund and having HUD manage the inventory."

I would submit that those are the wrong incentives. We need to encourage a different kind of behavior.

The GAO is correct. The current situation has been forcing us to collectively make the wrong decision for dealing with the management and preservation issues. It is simply not sound management for the Federal Government to try to manage and own this inventory. Such an approach has not worked in the past, and will not work in the future. It will ultimately increase costs and will adversely impact the affected tenants and communities.

I believe that the best way to preserve this stock as an affordable low-income resource is to return that stock to community and private sector management. If we are to spend the money, we need to spend it effectively.

Mr. Chairman, when the Secretary came to HUD, he inherited a problem that had been building for years. As I have just explained, this problem is complex and costly. It has taken a long time to get into this mess and will take a long time to get out.

We will have to make hard decisions to solve this crisis—for that's what it is—to cut our losses and to protect the insurance fund so that it can continue to help low- and moderate-income families to get the housing they need.

There are two primary thoughts we would like to leave with you and the Members of this committee today.

First, we at the Department are taking every action on every front that is statutorily permissible.

Second, we can't do it alone. We need your help to solve the problem. We need legislative relief, and we need it this year.

Senators I appreciate the opportunity to come here today and engage you in this discussion. You have seen the problem coming and we need to work together now to try to deal with it in the best way possible.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much for a very clear and lucid statement, and for some very innovative proposals on how to address these problems.

Given the number of people that are here, I think we should have 5 minute rounds and give everyone a chance to have an orderly round.

First of all, let me ask you this question. Have you been able to identify the factors that have caused things to go wrong?

If you had to give me the three or four causes of the defaults of properties either that you've taken over or that you're fearful that you're going to have to take over, what would they be?

Is it possible to identify those causes? To what extent are they generally applicable to the economy, such that similar problems are occurring outside of your Department as a result of general economic conditions? And, to what extent are these causes more specifically related to the arena in which you've been working?

Mr. RETSINAS. I think it's a little bit of both, if I could take a first crack at that, Senator.

In many ways, the best solution to this problem is to turn back the clock and not make loans that would eventually default. That's solution is not available to us.

But if you look back historically, as the Secretary's statement indicated, there are problems that were generic to multifamily housing across this country.

Over the decade in which these loans originated, the real estate market flattened in some cases, and in many cases, deteriorated badly. Certainly, many of the loans, and if you look at the regional disbursement of those loans, were affected dramatically by those various housing markets, and that affected the general marketplace as well as the Department of Housing and Urban Development.

Second, there are, unfortunately, some programs that were flawed. I think we all recognize that the coinsurance program, in retrospect, didn't work. And much of the problem we're facing today is a product of that program. It was a design that offered the wrong incentives at the wrong time. We need to learn from those lessons as we design new programs and new partnerships.

Third, there were some mistakes. Some of the underwriting and some of the appraisal practices over the years as we look back, were not appropriate. The results can be seen in the condition of the portfolio today.

If you talk specifically about HUD, the one matter that merited more attention than it got, and we now need to focus our attention on, is how do we institute an early warning system. How do we assemble information so that before the loans become seriously delinquent, we take those steps that are appropriate to stop that from happening?

With the information that the audit provides us, we are moving in that direction.

Senator SARBANES. One of the issues that's going to arise, obviously, and that we're going to have to address is the subsidization requirement. People often come in and say, "well, if we could dispose of these properties without paying attention to the affordable housing requirements, it would be a lot easier." In other words, some will suggest that we could move these properties into the more general and private market.

But then, of course, you lose the units for low-income people who desperately need housing, and, in fact, you would lose it—leaving aside the vacant properties to which you made reference earlier in this hearing, but addressing all the other properties—you would lose it for those people who now reside in those units and who are currently getting affordable housing.

Now, you've talked about a number of initiatives you wish to take. You may not have this answer at this point, but what is your estimate of whether there will be a decrease in availability of affordable housing units as a result of the measures you're thinking of trying to use in order to address the problems you've outlined?

Mr. RETSINAS. I don't think there will be, because right now—Senator SARBANES. You think there will not be?

Mr. RETSINAS. There will not be, Mr. Chairman, because, in many ways, right now we are paralyzed by good intentions. The

legislative initiatives, as you pointed out earlier, were certainly well-intended and appropriate to preserve affordable housing.

In a country, as Senator Dodd indicated, with the severe housing needs that we have, we cannot afford to fall back.

The difficulty is with the resources not available right now, we are estopped from acting. We continue to hold the properties and the properties deteriorate.

I think what we need is flexibility to decide where it is appropriate to save the particular units—to protect the particular tenants and the particular units—make sure we preserve affordable housing, and look at other alternatives in terms of using scarce housing subsidies.

So I believe that it would be inappropriate for this Department to seek, and for this Congress to grant, unilateral authority not to honor commitments previously made. But we need to find a way to do that prudently, and that's the subject of the legislation we hope to submit to you shortly.

Secretary CISNEROS. Mr. Chairman, if I may add to that. And first of all, thank you for excusing me in the way that you did.

Thanks, Nic, for continuing. And I think you can see from his answers, as well as the experience and track record that he has, that he is the right person to do this job.

Let me say, first of all, that the whole intent of this solution, as opposed to others, is to maintain the stock of affordable housing to the maximum extent possible. And I think this solution allows the vast majority of affordable units to be maintained.

Second, we have, in our internal discussions, explored the whole range of possible policy options. And over the years, it has been suggested that we ought to just be out of the business completely.

We've talked about that, but the price that we would pay, as a country, in terms of numbers of people who would actually leave housing that they're in today and be put on the streets, is, in my view, unacceptable. It's bad public policy. And, as a result, we've worked out a solution that resembles what Nick is outlining today as opposed to walking away.

Finally, whatever we discuss in a room like this, in the conference rooms of HUD, or any other Washington location, is in some sense far removed from where the problem occurs.

It is essential that HUD add the staff necessary and train the people that we have, because there are several elements of this that involve the quality of the people who are running the programs.

The quality of underwriting is directly related to the judgments that people make about the viability of projects, and whether or not those are bankable projects and supportable projects. And that's a training issue.

The judgments that we have to make now, to implement this set of solutions, require enhanced training. So a big part of this is a management job that requires improving the skills of the people that we work with to carry it out.

Senator SARBANES. I'm going to yield to Senator D'Amato for his questions, but I note we've been joined by Senator Kerry.

Senator Kerry, did you have a brief opening statement you wish to make?

OPENING STATEMENT BY SENATOR JOHN F. KERRY

Senator KERRY. Mr. Chairman, thank you very much, and I appreciate you letting me just say a couple of words, because I'm also chairing another hearing, and I need to return to it for a minute. But thank you for holding this hearing.

When you were last here, Mr. Secretary, a number of us raised this issue with you, and I'm delighted that you're back here now with a legislative response request, which I think is the only way to begin to proceed.

I would just like to note that, in point of fact, Mr. Chairman we need to understand that we're not just dealing with the \$12 billion but we're looking at \$4.6 billion that HUD wrote off when we last year did the credit reform, and then there was another \$4 billion that HUD already wrote off in the prior year, so we're really looking at about \$20 billion of property.

Senator SARBANES. Now I'm not going to enjoy my lunch today. I lost my breakfast on Sunday with this newspaper article, now I'm going to lose my lunch.

Senator KERRY. My sense is that—and there's a real gap between the request, the administration request, and reality. It's my understanding that if we were to live up to the section 8 requirement, that if you're going to take all these properties and try to put them out there as section 8, you're looking at a \$4 billion liability. Is that accurate?

If you're looking at a \$4 billion liability, you then have to measure that against only \$100 million that was asked for last year, and only \$93 million that Congress saw fit to actually put into section 8.

So it seems to me, we're not dealing with a very complicated, we're dealing with an uncomfortable, horrible, fiscal reality, but not a very complicated intellectual housing issue.

We either put the section 8 money out there, or you've got to let this property go back out into the marketplace where there is not section 8 money. And it seems to me, particularly when you're looking at the fact that most of this is multifamily housing, most of it unsubsidized, I mean, it's rather extraordinary that this kind of underwriting process has been allowed to take place for these past years.

And so, Mr. Chairman, I'd just say very quickly that, you know, the key here is to get a handle on it so that we're not looking at the \$248 million that I gather GAO says it costs us each year, because HUD, at this point in time—not your fault, but no one ever put in place a system for understanding what it's costing us—and HUD can't tell us themselves.

I think, Mr. Chairman, that we've got a bitter pill to try to swallow in a way that puts the least burden on the taxpayers.

Secretary CISNEROS. Senator, if I may, you put your finger on a very key portion of this, which is the adequacy of the section 8 vouchers and certificates. And there are interesting almost counter-intuitive dynamics that occur when the section 8 vouchers are not adequate.

For example, if the section 8 vouchers are not adequate, and you cannot act on a building because you cannot keep it affordable without the section 8, then the developer knows you can't act, and

they cease to maintain, cease to pay rent, etcetera, but there's nothing you can do about it, unless you're willing to let the building leave the affordable stock.

This is the dynamic at the local level that plays out. They know we're powerless, because we want to keep the units affordable, but we can't without the section 8.

Senator KERRY. I will just close by saying that I was going to read a portion of a letter that you didn't write, but somebody at HUD wrote back to me, because I was curious about this paralysis, and I wrote. And your response, through designee, was the following:

Without a real threat of foreclosure, owners of projects secured by non-recourse HUD mortgages have little incentive to pay debt service after HUD becomes the mortgagee. The present status of the inventory supports this theory. Over half of the inventory is in default. Most are not under a plan to cure the default, and when negotiations are opened, then HUD is placed in a weak position, due to the lack of a clear foreclosure possibility.

So we're locked into one of those classic catch-22 governmentally created snafus where we require something, we don't fund the something we require. The result is an even worse situation that we then are sitting here trying to deal with. And I think our choice is very clear, Mr. Chairman. We either get some money into the housing because it's valuable and we want to support it, or we put it back into the private sector.

But we've totally hamstrung the ability of HUD to do anything right now, and it's crazy.

Senator SARBANES. Of course, I want to be clear on one point, and then I'll yield to Senator D'Amato.

There's another source of money that's now being used, perhaps not wisely, and that's the money out of the FHA's General Insurance Fund, to cover the costs of housing that comes into the HUD portfolio. And if somehow you could credit that money, or find some way to put that over into helping to keep properties from coming into the HUD portfolio to begin with, it might be a very cost-effective use of that money. Am I correct in that perception, or not?

Mr. RETSINAS. One modification, if I could, Mr. Chairman. The General Insurance Fund—unlike the other FHA funds, for example the Mutual Mortgage Insurance Fund—was not expected, and is not required to be, self-sustaining. And as a result, it constantly requires appropriations from the Congress. So even the payment of claims, the payment of holding costs through the FHA Fund, is a cost to the taxpayer through the appropriation process.

It's a different kind of expenditure, you're absolutely right, and that's why, in the Secretary's statement, we wanted to talk about a more efficient way of spending money.

The General Insurance Fund does, in the end, also require an appropriation by the taxpayers to make that fund solid.

Senator KERRY. Mr. Chairman, could I just add one final observation?

It occurs to me that in addition to your being in a weak position on foreclosure, and in addition to the owner sitting there realizing that, the owner, while not paying on the mortgage, is still collecting the rents. Is that not true?

Mr. RETSINAS. Yes, it is, because to withhold, for the reasons that you're leading to, I believe, because to withhold the rents would be a disservice to the tenants. That's the problem.

Senator KERRY. Precisely. I mean that is just unacceptable. I mean, that's crazy, and I think the point is made.

Senator SARBANES. Senator D'Amato.

Senator D'AMATO. Thank you very much, Mr. Chairman.

I was just trying to get a little handle on this. It seems to me that we've got a lot of this housing that's falling into the FHA inventory where there's a mix, isn't that true, where you have some housing which was not subsidized, as well as the certificated section 8 housing?

Mr. RETSINAS. They're both subsidized and unsubsidized, correct, in the portfolio.

Senator D'AMATO. In your disposition, will you be attempting to continue that which is unsubsidized in that kind of manner? You're not going to try to get certificates for all of it, are you?

Mr. RETSINAS. Well, the legislative requirement, Senator as I understand it, is that in an unsubsidized development that is occupied by low-income tenants, we are statutorily required to treat that as the equivalent of the previously subsidized.

Senator D'AMATO. Well, let me suggest then, if you're going to continue in that vein, we're going to be holding out these laudable goals, and you're not going to be able to really get disposition to credible managers who are going to maintain the properties and create an atmosphere and environment where people want to live. You're going to get the quick buck operators who are going to come in. I've seen that before.

And I believe that you should avail yourself of the opportunity to have increased flexibility and to maintain some kind of ratio as it relates to free market, as well as the certificates and other HUD subsidy programs. Do you intend to do that in your legislation?

Mr. RETSINAS. Yes. We will be seeking flexibility that will permit—more than permit—encourage the use of mixed-income developments, because we think that is a way to minimize the public cost, but at the same time preserve affordability. We will be seeking that balance, Senator.

Senator D'AMATO. Good. Because it doesn't make sense to say that all 10,000 units, hypothetically, that are now allocated to low-income families be kept in that way if you're not going to be able to get more than a fraction utilized.

What's the sense of saying, well, it's a laudable goal, but in fact, by maintaining rigidity, lose the opportunity to let's say get 7,000 used by low-income or 3,000 by low-income, and have occupancy, as opposed to having a distressed management situation, which is horrible.

Mr. RETSINAS. It is that rigidity that we seek relief from in our legislative initiative.

Senator D'AMATO. Well, I'm very encouraged, and I look forward to working with you to see this in some form of detail. I know this was not the purpose of this hearing to go into that, but I look forward to working with you in that area. There will be advocates who will say you've got to maintain every single one of these units as subsidized housing, and they will be doing a disservice when

they do, and if you don't have that flexibility to maintain the kind of ratios which will attract good sound management and operation. The situation won't get any better.

I think you're going to come under some attack, but Nixon went to China and maybe this administration can deal with the pressures of the advocates of housing and get them to understand that you need some kind of balance.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much, Senator D'Amato.

In fact, we have this next panel, I think will probably get into that issue to some degree.

Mr. Chairman.

Senator RIEGLE. President Nixon not only went to China, but he imposed price and wage controls. He did a lot of things.

I'm wondering, in terms of a disposition program, or a course of action that you might follow here, because of the extraordinary problem that's been laid out quite well here—I'm wondering if maybe there isn't a way to conceptualize using non-profit groups, church groups, community-based organizations that have the horsepower to really take on serious projects of this kind, foundations, public interest foundations that exist all over the place.

I'm wondering if we, as between either running a Government subsidized program that's very difficult to manage at best, or just spinning it out to the private sector where you run into this problem making the economics work and still taking care of low-income people.

In order to not have a situation where you're forced to choose between unpleasant options, neither very workable, if maybe there is a way to bring some new players into the game by thinking about what it is we want to do here.

Do we want to solve a complex financial problem, do we want to get sort of arm's length people involved to bring the right motives and the right management capabilities?

And, I mean, maybe they have to be private sector firms to be hardnosed enough to sort of work off a profit motive to do it, but it seems to me then you run the problem of sort of a widespread displacement of people.

Maybe there's a way to think about how we might draw in some people to take on this assignment in the public interest, to try to save the money and to save the facilities and to bring the management in place, and to see to it that low-income people are not sleeping on park benches or living under bridges or in cardboard boxes or in doorways.

So I raise this suggestion to you. Are we sure that we've changed our procedures in such a fashion that we're not entering into new arrangements now that are likely to end up in this troubled status later?

How confident are we that our current practices have been altered sufficiently and the right risk characteristics are being taken into account? And if coinsurance was the problem before, is that now fixed?

Looking ahead, how confident are you? Can you give us a reinsurance today that we now know what we're doing? Given the va-

garies of real estate markets and all these other things, I mean, are we to that point?

Mr. RETSINAS. That's an important qualifier. Let me emphasize the qualifier and then talk about some of the things we've done to ensure that we don't have an analogous problem.

Let me say, at the outset, multifamily housing is a high-risk business, particularly when you're trying to meet what are the necessary housing needs of low-income families and low-income individuals throughout this country.

So, Senator, I'm not going to sit here today and say that we will not have another delinquent or defaulted loan. As a matter of fact, if we had none, then I would wonder whether or not we are reaching out to kinds of different groups and individuals we need to work with. I think it is a fair question to ask, however, if there are procedures now in place to minimize that risk.

Our goal at the FHA is not the avoidance of risk; it is to minimize risk, and to tolerate the minimum amount of risk that is prudent to allow us to make progress toward our overall housing policy goals.

We have done a number of things. As the Secretary indicated in his statement, we have enhanced the training of appraisers. Certainly the appraisal, understanding what is the value of the property, is fundamental to a lending decision. We need to spend more time doing that. We've embarked on that, and we have more to go, and we need to do even more than that.

Fundamental to the new delivery system, and I think we can learn lessons from the coinsurance situation, is the risk-sharing program which this committee, in my mind, very appropriately authorized last year. And I might say, if you hadn't authorized it, we ought to do it anyway, because it's the right thing to do.

I say that, in part, having come from a housing finance agency. If you look at State and local housing agencies around this country, many of them have excellent track records. We need to take advantage of, and work with them in, those track records.

Unlike coinsurance, the State and local governments that we will partner with will not be able to walk away, because they have a vested interest.

We will also ensure in program design that there is recourse and shared risk throughout the process; not at the front end, leaving the Federal Government holding the bag, but throughout the process. That is the way partnerships need to work. You need to share risk throughout the process, not just at one stage, to create the proper incentives.

I think with those kinds of actions, we can begin to get a handle, and I think begin to answer that question as positively as we can. We do intend to minimize the risk to any extent we can.

Senator RIEGLE. Let me ask you two other questions, just briefly, if I may.

I have data that indicates that HUD owned about 10,000 apartments through insurance foreclosures in roughly 1990, but that figure, as the result of foreclosure proceedings that are now in the mill, is going to ratchet up to as many as 69,000 units. Is that right?

Mr. RETSINAS. That's correct. The 69,000 refers to a number that, if we proceed with the foreclosures in process, which we do not do now because of the subsidy limitations, that number would be about 69,000-70,000 units. Correct, Senator.

Senator RIEGLE. Also, the data that I have indicates that over the last 10 years, the Department staff has been cut from about 17,000 to about 13,500. Is this correct?

Secretary CISNEROS. Correct.

Senator RIEGLE. When you look at the problems that you're now facing are those cuts serious obstacles to resolving problems in the Department?

Secretary CISNEROS. They have hurt us.

Senator RIEGLE. Are those cuts part of the problem?

Secretary CISNEROS. They are part of the problem.

Senator RIEGLE. Do we need to restore some people? I'm all for the training, retraining, upgrading, et cetera, but do you need some additional people on the theory that sometimes it's better to spend 5 cents and save \$5?

Secretary CISNEROS. Yes, Senator, we do need additional people. However, the reductions across the board in the Government and so forth, make it very difficult for a department to ask for more people as dramatic cuts are occurring all across the Government. We have discussed, in recent days, the results of the reinventing HUD process, and the possibility that we would lighten the number of people in some of our regional offices, for example, who are performing other functions that may not be as critical as this, and select persons for reassignment where the skills are applicable, and in other cases, simply downsize and use the slots for these high-priority needs, where we have emergency priorities. So those kinds of resource management challenges are what we're working on.

Senator RIEGLE. Thank you.

Secretary CISNEROS. Senator, I might say a quick word about the portion of your question that dealt with community organizations.

We now have a strong effort underway to engage community organizations in disposing of the single-family properties on a wide-spread basis.

Nic has set a priority in several cities, notably, Chicago and Richmond, where we have set up laboratories, if you will, to prove that community organizations can, on a really intense basis, help us dispose of the single-family stock.

I was in Chicago this last weekend, met with a number of community organizations, went to neighborhoods, the Roseland neighborhood in Chicago, where some 90 HUD properties are owned, and where they're deteriorating daily because we have not been able to move them back into the stock. We're making good progress on that score. The community organizations are working with us.

Using community organizations for multifamily is a more difficult proposition. It's a question of scale and management skills, so while we will work on that, and we have explored it and discussed it, I don't expect that's going to be the bulk scale solution to this issue.

Senator RIEGLE. You almost wonder if we wouldn't be better off getting competent third party public-interest type groups involved to have the serious intention to work at the neighborhood level and

in tough areas. Even if we had to set up some kind of a national consortium in which they could participate, if we're going to spend the money, maybe we should spend some of the money to finance the talent to augment those organizations so that they can improve their capability, so that they can come into this vacuum.

Right now, I'm torn because I don't see anything that really provides the kind of capability somewhere in the middle that can work us through this problem. We may have to actually build it, may have to sort of go to a design laboratory and say, look, what's not out there is this kind of arm's length management capability of people who are willing to step up to the plate and help work the country through this problem, and help people in the process.

And can those people, if they exist, once enfranchised and empowered and given the wherewithal to come in and do this job, maybe they can do it a lot less expensively for us. I don't know. I'm just putting the question on the table.

Mr. RETSINAS. I think you're on the right track, though it is important to note, as diverse as this country is, it is even more diverse in the capacities of local community groups and other kinds of organizations.

One of the initiatives that the Secretary has asked us to explore, we've already begun meetings, is with local public housing authorities, particularly in smaller communities. Some of them have excellent track records in managing properties.

Senator RIEGLE. Right. Well, maybe that's the way to go.

Mr. RETSINAS. But that won't work all across the country. In some places, the track record isn't as good; it's a mixed bag, as with everything else. But we are working very closely, I've already initiated meetings with my colleague, who is a very competent Assistant Secretary of Public and Indian Housing, Joe Shuldiner, and we'll be meeting with local public housing authorities to explore what role they might have in the acquisition and management of these properties.

Senator SARBANES. Good.

Senator Bennett.

Let me say, although you're not a Member of the subcommittee, we're obviously very pleased that you've joined us this morning.

Senator BENNETT. Thank you, Mr. Chairman, I appreciate that courtesy and do feel welcome here.

Let me try to understand a little better where we are. I've made some notes, Mr. Retsinas, as you talked through, several of the comments that you've made.

You say the problem exists for three reasons; the real estate market deteriorated, the coinsurance program didn't work, and there were a number of mistakes made, particularly with underwriting and appraisals. Then later on, you made the interesting comment, you summarized and said, we're paralyzed by good intentions, and you made the comment that multifamily housing is a high risk business, particularly when you're dealing with people with low incomes.

High risk business attracts people only if there's high reward. There's always someone who's willing to take a high risk flyer on something if there is the potential of a high reward.

I gather, in this circumstance, the potential for high reward is not there for the private entrepreneur. Is that a fair summary, without some kind of HUD intervention that reduces the risk?

Mr. RETSINAS. The private sector, generally speaking, is unable to respond, to affordable housing needs without some kind of subsidy to close the gap between the cost of housing and the capacity of low-income families and individuals to pay for that housing.

Senator BENNETT. In other words, to cut down the risk.

Mr. RETSINAS. To cut down the risk or, really, to make it feasible, even beyond cutting down the risk.

Senator BENNETT. So it becomes the function of the Government, then, because there is a sound public policy reason to have housing for these people, to reduce the risk or raise the subsidy, and thereby attract private capital. Is that the process that we're talking about?

Mr. RETSINAS. It is the public policy objective of affordable housing that, in my humble estimation, justifies the engagement in this high risk-kind of venture.

Senator SARBANES. Could I interject there, though? I want to be very clear. Even with the subsidy, you're still dealing with a high risk business.

Mr. RETSINAS. Multifamily lending generally and generically has been a high-risk business.

Senator SARBANES. And the subsidy which makes it feasible does not eliminate the high risk? The high risk remains, does it not?

Mr. RETSINAS. That's correct.

Senator BENNETT. Yes, and that's where I'm going, Mr. Chairman, that you end up attracting people, private operators, into the circumstance who are not willing to take a risk. Who are coming in, looking for a fairly stable circumstance and saying, well, the Government is going to remove the risk by virtue of the subsidy, so that I can get into this and I can make a buck, and I am not running the high risk because there is no high reward.

Mr. RETSINAS. But the purpose, the fundamental purpose of the Federal Housing Administration is to absorb risk. That's the credit enhancement function. And in doing that, private owners, not-for-profit owners, the variety of actors we talked about, are willing, on occasion—not as often as some of us would like—to engage in these endeavors and produce this affordable housing.

That's correct, Senator.

Senator BENNETT. The dilemma that I see we're getting into here is that if the attraction is not there for the kind of people that we want managing these properties, we somehow have to change that because, by your statement, you say we're not good landlords. We're not equipped to do this.

The problem is, how do we attract the good landlords into a high risk situation if there is no high risk reward that they can look forward to? And I think the problem is finding some kind of balance here that says, OK, we will attract competent management, we will get people who are willing to get into this for sound business reasons, and at the same time, we will create a sufficient balance that it becomes an acceptable risk.

I don't think we ever want to get into the position where there's no risk, because if we get to the position where there's no risk, then

it's fully subsidized, the Government runs it, and we're in the British housing project dilemma. And I have lived in British housing projects, and I know we don't want to get to that circumstance.

So we want private enterprise in here, but we want to attract them with sufficient promise of reward to get the kind of competence that we need, and at the same time, we recognize that we don't want to so protect them, as ultimately we ended up with the savings and loan circumstance, that we're saying that incompetence will be rewarded, and they can take enormous fliers without any downside risk.

As you craft your legislation that you're going to bring to us—and I'm satisfied with the effectiveness of your presentations here this morning that you're approaching this in the right fashion—could you keep that balance in mind? And we always thinking in terms of the kind of entrepreneur that needs to be attracted here that will give us the management expertise that you say has been lacking?

Because I have the sense, as I listen to you, and a number of people have said, well, let's go into this, and the Government will protect us, and we really don't know what we're doing, but maybe we can make a buck on this. And then when it starts to go sour, they say, well we made a mistake, and they walk way and leave you holding the bag.

Secretary CISNEROS. Us holding the bag.

Senator BENNETT. Yes, us holding the bag. And we've got the wrong kind of dynamic. Is that a useful kind of perspective, or am I off base here?

Mr. RETSINAS. I think it's useful, though I must say, Senator that part of the concerns you have really have to do again with the generic incentives that exist in real estate. Up until recent years, many of those incentives were tax-driven, which is to say, did not rely on the sound financial footing of the developments, that is, the cash flow.

While a negative byproduct, an unanticipated byproduct, of some of the tax reform efforts was the devaluation of real estate and resulting impact on the FHA fund, a positive byproduct has been more of a reliance on the underlying financial or cash flow, to use the jargon of real estate. It's important to understand that.

Second, a balance is absolutely important. I mean, if there is—and I'm not a Pollyanna—with this data, you cannot be a Pollyanna, but if you look at the data, there are almost 2 million units that are current and performing. That is, there are almost 16,000 mortgages where it works, where the private sector or not-for-profit sector have received the mortgage, it is properly insured by the FHA, and is delivering an important affordable housing need.

The issue is how do we find which of those incentives are the prudent ones, so we do share some kind of responsibility. I think it is an obligation of the Government, and of FHA, to monitor that closely. As meritorious as a particular program design is, having the capacity to monitor its implementation is perhaps more important.

Senator BENNETT. Well, if I may just quickly, Mr. Chairman, I agree completely that a major component of our overall real estate problem has been the fact that the tax laws, for many years, en-

couraged people to invest in real estate that had no intrinsic market value and was held up by artificial tax props. And that didn't make any sense, and we ultimately had to pay the piper as a Nation for that kind of mistake.

Whether we overreacted with the 1986 Tax Act, or something, we could philosophize about that some time, but the demand is there. You know, we say the real estate market deteriorated. A market deteriorating, by my definition, means that the demand is drying up, and therefore the market goes away.

Obviously, the demand for low-income housing is there, the market is there, and the challenge is, how do we meet the demands of the market with the best available management expertise, and attracting the right amount of capital. And that seems to me to be the overall economic dynamic in this situation that we need to look at as you craft your legislation.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much.

Senator Dodd.

Senator DODD. Very briefly, Mr. Chairman, because then we want to get on to the second panel, I just want to underscore the point that was made by Senator Riegle about non-profit organizations.

I appreciate the response given the complexities of dealing with multifamily housing, but I would hope we might try some test cases to see whether or not there may be a greater role for non-profits.

Second, Mr. Secretary, I'd ask you maybe to comment on, and Nic, maybe you ought to comment on this as well, but the idea of hiring or utilizing contracting out, if you will, private management firms to deal with the monitoring and managing or disposing of properties. Because, frankly, I don't see us getting a whole lot more staff for you. I appreciate your complaints, but the fact of the matter is, it is unlikely we'll be able to get you much more staff, given budget constraints.

Are there existing firms out there that have the expertise and the knowledge to do what I've just suggested?

And third, Nic, you may have commented more extensively on this and I apologize if I missed it, but you made a very good point, and perhaps you could elaborate on, the need for early identification.

The Secretary mentioned a staff problem, and I appreciate that may be part of it, but aside from that issue, what steps or what ideas do you have in terms of how we might better detect, early on, the properties that are in that kind of situation?

I apologize for lumping these issues together, but would you care to comment on them?

Secretary CISNEROS. Senator, let me begin by speaking to at least a portion of it. We hear you loud and clear on the non-profit sector.

And, as always, these things involve people who know the field. And I'm very pleased to introduce to you this morning a lady who comes very highly recommended, and who was on every list as one of the top housing officials in the country, whose expertise includes

non-profit development, who's going to be part of Nic's team for this workout.

Her name is Helen Dunlap, and she comes from California, where she has been the Chief Executive Officer of the California Housing Partnership, a bipartisan agency developed to address the preservation needs in California, as well as the operator, before that, of a local non-profit group, and a financial adviser, prior to that, working on the development of multifamily housing. So she knows the finance of multifamily housing and the non-profit sector's role in it.

Helen, would you please stand so the Senators can recognize you?

She brings a real knowledge and professional expertise.

Senator SARBANES. You've just had a very heavy burden placed on your shoulders, Ms. Dunlap. Good luck.

[Laughter.]

Ms. DUNLAP. I arrived on Friday.

Senator DODD. By the way, I couldn't agree with you more on the need to get State housing finance agencies and housing authorities involved. One of the byproducts of having a smaller Federal role in housing for the past 12 years was that, out of pure necessity, local communities across the country developed a rather remarkable expertise. There's a lot more confidence today, I think, in far many more jurisdictions around the country. I've certainly felt, and I think to the disappointment of some, I felt far more comfortable in the last few years about relegating to local communities a lot of the decisionmaking process, because I was much more comfortable with the knowledge base and expertise that existed across the country.

Secretary CISNEROS. Senator, I think that's a very good point, and I do rely personally fairly heavily, having come from the municipal sector, on the capacity that I know exists in many housing authorities.

It might be worthwhile looking at some models with those housing authorities that are among the more innovative, and there are many who have set up non-profit corporations and so forth for a whole range of purposes that are doing very good jobs at innovation.

I think it's also important to work with the CLPHA, NAHRO, and other organizations of which the housing authorities are part, to spread more broadly the model of innovation.

I also think we may need your help at some point, because there is kind of a fault line among the non-profit and public sector housing producers, between the non-profits and their disdain, in some sense, for the housing authorities. And so, if we're going to do some of these things, we may need a little interference from some of you, basically helping articulate the scale of the problem and why we need all the players to do what they can.

Senator SARBANES. And the State housing agencies, as well as the local housing authorities, especially in your States can be very effective.

Secretary CISNEROS. And in fact, that's where the risk-sharing effort would primarily be focused—on the State housing authorities.

Senator SARBANES. I think that you can work some of this out with certain localities, where you have either a strong State housing agency or a strong local housing authority. And often, when you have the involvement of the localities, you have a more responsible private sector at work as well, because of the interaction that takes place.

So, we can show some winners in certain areas of the country. We can show that this can be done, and use these winners as models for those parts of the country that are having problems.

Secretary CISNEROS. Senator, let me say, from a management standpoint, how we're dealing with some of this.

The President and the Vice President have set up this National Performance Review on reinventing Government.

Now one aspect of that was to force us to select what are called "reinvention labs," where we will do things decidedly differently by September 1993, to show some results, some places where we reinvented between the time we came to office and September.

We've selected, in the FHA area, the disposition of single-family housing as a reinvention lab that's to show results by September.

Now, at HUD, we've gone one step further and we have created a series of first-year projects to show results in a year, discrete project-oriented things that can show results in a year.

The disposition of single family housing and the production of new multifamily through risk-sharing arrangements are two of the areas that Nic has selected for FHA.

We had a conversation last evening in light of this situation, about including both the disposition of multifamily units and the attempts to save some of the stock from reaching this point, this \$11 billion scenario, as things that we could demonstrate on a project basis in the first year. So we will take your points here about non-profit public housing and others, and make a first-year model out of some aspects of this.

Senator DODD. Would you just quickly comment, Nic, on my other two points?

Mr. RETSINAS. On the contract issue, Senator?

Senator DODD. Yes.

Mr. RETSINAS. Because of the realities of scarce staffing, which you alluded to, we already are doing quite a bit of contracting. And it's been useful in certain areas. As you well understand, you cannot contract authority, if you will, but you can delegate parts of the process. And because of the procurement policies of the Government, it requires staff appropriately to oversee the contracting. So we can go only so far in that area.

We need to do more, and let me give you a specific example of a contracted function that I think will tie to your second question, which I believe had to do with the early warning, early detection.

One cannot look in a—there's not a crystal ball that I could buy that could tell me this particular project will go delinquent and will default at that period of time. If there were, I would do so, and would save you the trouble of wrestling with this issue, but I cannot do so.

There are, however, some early warning signals. Having administered a housing finance agency, one of the things we looked at very closely were the financial statements, both the operating

statements of the individual projects, as well as the financial statements of the sponsors behind the projects.

And when we started to see a deterioration or change in those statements—for example, an inability of the sponsor to contribute to required escrow accounts, or a reaching into the replacement reserve and bringing that to unreasonably low levels—those were telltale signs. They were signs to us that we needed to intervene and find a way to make those projects healthier.

We are currently in the process of going forward with a contract that will allow us to use a contractor to assemble those financial statements and to bring those financial statements for analysis by our HUD field staff.

Saying that, I don't want to sit here and say that will be enough. If we do not—I hate to be on topic here, but it's an important one—if we do not make a dent in the inventory and in the HUD-held mortgages, the field staff will be stretched even to look at those financial statements.

So that's why these are connected statements. There is a role for contracting, and we need to make sure that we hone in on what's the appropriate role. You're absolutely right.

Senator DODD. That's the difference between the authority and the responsibility, and that's a very good distinction to make. Certainly, we're not likely to give up the authority, but we'd like someone to handle the responsibilities.

Thank you very much, Mr. Chairman.

Senator SARBANES. Thank you, Senator Dodd.

Mr. Secretary, we very much appreciate your testimony. As always, we're torn—I mean, we could keep you here all day and into the evening, but we have the other panel, and I know you have other responsibilities, as well. Let me simply say that I think this was very practical and tough-minded testimony that you have presented to us this morning.

I'm encouraged by the clear analysis that you are making of the problem, and the thought that you are giving to solutions. And we very much look forward to working with you in that effort. We obviously hope to nip this thing in the bud. It's actually beyond the bud now, given the costs, but we must contain it and move on.

We very much appreciate your being with us once again before the committee.

Secretary CISNEROS. Thank you.

Two quick closing points.

The first is that we have said all along, before this committee, when you've asked me about priorities and asked me to state priorities, that this issue of getting to the core management problems of the Department was our number one priority. It is, it will continue to be, until we feel that we've got a handle on these things.

Sometimes we will pass on sort of silver bullet magic solutions on other fronts in order to put our time and energy into these kinds of problems. You will see that as a consistent pattern.

The second is that it is always helpful to us to prepare for a hearing such as this, because it focuses our attention internally and so this is not, by any stretch, a side light to our work. This is part of the very important focusing which your oversight responsibilities make necessary. So we indeed appreciate the opportunity.

Senator SARBANES. Thank you very much. We appreciate your being here.

If the next panel would come forward and take their places, we'll proceed.

And Nic, I understand you're going to sit in?

Mr. RETSINAS. Whatever you like, Senator. I'd be happy to, if you feel it would be helpful.

Senator SARBANES. Well, it might be. We won't take a statement from you, but unless you have other pressing matters, maybe you could take a seat right at the end, and then you could participate in the discussion.

I'm pleased to welcome our second panel, composed of people who've had significant experience in multifamily housing.

Mr. Retsinas will sit in.

We've already, of course, heard from him and we appreciate HUD's willingness to sit on this panel, and have the chance to interact with some of our private sector witnesses. I think that's very important, and I think it reflects a kind of open and positive attitude at HUD—trying to draw in all the views that they can.

This panel consists, first, of Alan Cravitz, who is the president of Developers Mortgage Corporation in Chicago. Mr. Cravitz has long been involved in helping owners finance HUD insured properties. He will bring insight to these problems from a lender's perspective, and we particularly want to hear his views of HUD's underwriting and processing practices.

James Grow is a staff attorney with the National Housing Law Project in Berkeley, California, who's been in the legal services housing arena for many years. He has testified, in fact, before the House Banking Committee on the issue of multifamily property disposition a decade ago. We'll have the benefit of his very sharp perspective on the concerns of tenants of these properties, concerns which we've already discussed to some extent this morning.

We're also pleased to have Jim Logue on the panel, the Executive Director of the Michigan State Housing Development Authority, who's testifying today on behalf of the National Council of State Housing Agencies. He's also recently served as Deputy Assistant Secretary for Multifamily Housing at HUD, so we'll have the benefit of his former experience as an insider, so to speak.

And our last panelist is Ronald Ratner, president, Residential Development, of Forest City Enterprises in Cleveland, Ohio. Forest City Enterprises has been in the HUD-insured multifamily business since the 1940's. As I understand it, one-third of Forest City's multifamily interests are in HUD-insured multifamily properties located across the country. We'll be interested to hear from Mr. Ratner on his insight as to what it takes to develop, own, and turn around HUD-insured properties.

Gentlemen, we'll include your full statements in the record. The morning has gone on quite a bit. We appreciate your patience in staying with us.

If you could summarize your remarks in a fairly brief period, then we can get to a discussion and the opportunity to ask you some questions.

Mr. Cravitz, why don't we start with you, and then we'll move in the order in which I introduced the panelists.

**STATEMENT OF ALAN CRAVITZ, PRESIDENT, DEVELOPERS
MORTGAGE CORPORATION, CHICAGO, IL**

Mr. CRAVITZ. Thank you, Senator.

I wanted to first tell you how much I appreciate the opportunity to be here, and also to thank HUD. While I'm here today, back in Chicago, we are closing on a HUD-owned project that is being sold to a local neighborhood group to be used for low-income housing, eventually for co-op conversion. It's a property that had been in the HUD inventory for something like 11 or 12 years, and finally, with the new administration trying to work to get these projects moving, we were able to close, I hope, today. I haven't called the office yet, but I'm hopeful, and everything looked good as of yesterday.

Senator SARBANES. Maybe Mr. Retsinas should call his office to make sure it happened.

Mr. RETSINAS. I'm even more hopeful.

Mr. CRAVITZ. In my written testimony, I go into detail over some proposals for dealing with two of the three components of the Secretary's earlier testimony, the problem of the HUD-held mortgage portfolio, and also some ideas, suggestions, thoughts on preventing further defaulted loans.

Many of these are tools that already exist, that need to be refined, but that are there. I think that with a little fine-tuning, these tools could be available in short order without the need for much legislative change, if any.

I wanted to talk about, and I realize we don't have much time, ideas for HUD selling projects that they currently own, which I don't really touch upon in my written testimony.

The numbers of projects get a bit confusing in that many of them deal with what HUD defines as unsubsidized project, market rate housing projects that HUD has taken back over the years, and others deal with subsidized projects, projects that have been either financed under the 221(d)(3) or 236 programs, or contain some portion of section 8.

From HUD's standpoint, the ones that really would require some action by Congress, in terms of providing additional subsidies, are those subsidized projects that HUD either now owns or may be owning shortly.

I wanted to point out, though, that the Senators and HUD seem to use interchangeably the terms affordable housing and low-income housing and the statute even talks about something else called very-low-income housing.

I don't really look at these three terms as being exactly the same and I think that dealing with the issue in terms of the type of funding may be required really needs a much clearer definition of what is very-low-income housing, what is low-income housing, and what is affordable housing.

Most of the units that we're talking about were built in the late 1960's and early 1970's really as affordable housing projects. These were projects that had some sort of interest rate subsidies attached to them. They weren't projects that had rental subsidies.

It was only later on that the need became apparent to add some rental subsidy, either through the rental assistance payments programs or the rent supplement programs or the section 8 programs,

that rental subsidies were added to these affordable housing projects that were built 20 years ago.

One of my suggestions, in terms of some of the legislative changes, would be to clear up the definitions of what is affordable by requiring section 8 subsidies, if it's needed at all, only for those tenants that are very-low-income tenants.

There's one remaining project in Chicago owned by HUD. It's not a subsidized project. It's an unsubsidized project, but has many residents who are low-income residents, low-income defined as residents in the 50 to 80 percent of median income bracket.

HUD has been holding off on selling this property for years because of the unavailability of section 8, which HUD feels, and I think they're right, is necessary based on the current legislation.

It turns out, however, that the rents in that project right now are significantly less than what a tenant in the 50 to 80 percent of median income bracket, the low-income bracket, would pay if they were to receive section 8 rental subsidies and be required to pay 30 percent of their income. So in effect, we're waiting to receive subsidies that would be of really no benefit to most of the tenants who are currently living in this project and who can afford to pay the rents that are being charged in this development.

I'm afraid that there may be many more developments that fit into that same category, waiting for subsidy, that really don't fit the particular needs of the current tenants.

I ask that someone possibly look into this, and maybe a legislative change be made that would eliminate the section 8 requirement for low-income tenants.

I also think that providing section 8 subsidies—I'm not sure this is the proper time to go into detail—but providing section 8 subsidies for low-income tenants really in effect changes around the character and nature of a development. I'm really not certain that taking projects that, in many cases, are affordable moderate income resources, with tenants paying rents of \$300-\$400 a month, and redefining them as section 8 very-low-income projects is really the intention of the property disposition program.

I think that we've made that mistake, and hopefully it can be corrected, with the preservation program, where projects that are moderate income, affordable housing projects are being turned into very-low-income projects by the provision of section 8 and at great expense.

One of the proposals I suggest is that to the extent section 8 funds are necessary to sell projects in the property disposition inventory, the place that we may look to find it is the preservation program where other tools are available to allow those projects to remain as affordable housing resources. These tools would still enable HUD to compensate owners for the fact that they can't prepay, while at the same time, not use as much funding as the section 8 program requires.

Actually, I've submitted a proposal to HUD, which I hope they will consider, that would make some changes to the preservation program that I think would be very positive, both from a financial standpoint and a social standpoint, as well.

I should stop now since time is brief. I have other ideas that maybe I could put into some written form when I get back and

present to the committee or discuss in the question and answer segment of the hearing.

Senator SARBANES. If you would, we'd be very pleased to have it. Thank you very much.

Mr. CRAVITZ. Thank you.

Senator SARBANES. Mr. Grow.

STATEMENT OF JIM GROW, STAFF ATTORNEY, NATIONAL HOUSING LAW PROJECT, BERKELEY, CA

Mr. GROW. Thank you, Mr. Chairman.

I must say it's very refreshing to come to a hearing like this, after all these years of working on the preservation issue, both with troubled projects and with the prepayment eligible inventory, and hear statements from HUD that really are qualitatively different than what we have heard over the last decade.

I think it makes our job much more manageable because we're not fighting about the issue of whether or not generally this housing ought to be preserved for low-income and very-low-income families. And I appreciated very much the remarks of Secretary Cisneros and Assistant Secretary Retsinas that they're not looking for ways to backtrack on the fundamental preservation commitment. I think that's very, very important. That can allow all the players in this process to really focus on developing solutions.

I wanted to try to shift the focus, though, away from what I think is an inordinate focus on the fiscal consequences of the problem that has been described.

These days, everyone wants to talk about money, and money is important. And I think you don't solve these problems by attempting to pretend that there's a quick fix or that money isn't a critical part of the solution.

To the extent these buildings are occupied by very low-income people, and Mr. Cravitz has given some examples where maybe, in some cases, that's not true. But I think if one were to look at the occupancy profile of the formerly subsidized inventory, it is predominantly very low-income people. I'd hazard a guess of probably 80 or 90 percent of the units are occupied by people below 50 percent of area median income.

It's very difficult to provide decent and affordable housing to fix this housing up, to pay the operating costs, to pay any acquisition costs of transferring it to a new owner, without a section 8 subsidy. And we've got to get a handle on the number of section 8 units that are going to be required to perform this mission.

HUD has not done that over the last 5 years. And I think that historical perspective is critical. The property disposition inventory—the section 8 subsidy to dispose of it—in the early days of the Reagan administration was 10,000 units a year. Now, in the recent past, it has dwindled to 900 or 1,000 units a year.

That is, in large part, according to GAO and everyone who's looked at this, part of the cause of the paralysis that we now face. No one has been advocating, with the Appropriations Committees, to obtain the section 8 subsidies that are necessary to run this authorized program.

Had that been done regularly throughout the late 1980's and early 1990's, we wouldn't be having the numbers, at least with re-

spect to the HUD-owned inventory, that HUD presented this morning. So that's going to have to be big part of the solution.

Why? Because the needs are there and the needs are growing. The number of families who are very low-income in need of housing assistance is steadily increasing as the private market becomes increasingly unable to meet those needs at affordable rents.

The housing needs of very low-income families are the most critical, and whatever preservation solution we devise needs to focus on whether or not using these buildings as a way to meet those needs is in fact an efficient and wise use of Federal resources.

Congress has already answered this question, yes, in virtually every Federal housing program. In the public housing program, the FHA prepayment eligible inventory, and here in the FHA troubled inventory, Congress has already said preservation is the most cost-effective way to meet these needs.

We need to know who's in these buildings. They are predominantly very low-income people, they are also people of color. HUD's fair housing obligation should inform the solution that is crafted. We have a responsibility to ensure that the housing conditions provided to people of color are as good as the housing conditions provided to tenants in the prepayment eligible projects that are getting fixed up, and the FHA-insured section 8 inventory, the new construction inventory, which is probably much whiter in its occupancy profile.

I wanted to spend just a moment talking about the number of units at issue here. You've heard 69,000 units bandied around. Of that number, some of it is currently HUD-owned, but the bulk of it is "under foreclosure."

From the GAO's report, it's hard to tell what the term "under foreclosure" means, and that has tremendous significance for determining when subsidies will be required to dispose of that inventory.

As you know, the foreclosure process takes many years in some cases. It may be that those units are not going to go to foreclosure sale in this fiscal year. The current need may thus be much less than what has been indicated. Remember, also, that of those 69,000 units, only 26,000 to 30,000, the number varies between HUD headquarters and the field offices, is under a preservation mandate.

The law already allows most of those units to go without section 8 subsidies. I suggest that therefore we ought to be thinking about ways to do more, not less, not cutting back on that preservation commitment.

Finally, we need to figure out ways to avoid repeating the same mistakes of the past 15 or 20 years of the program. We need to figure out ways to get accountability into the system.

Of all the remarks that have been made this morning, no one has ever mentioned the tenants. I suggest to you that the residents of these buildings can perform an invaluable service to HUD and to the Congress if they are permitted to be full players in the process of operating this housing and in determining its future.

Senator SARBANES. Thank you very much. Interesting statement. Mr. Lodge.

STATEMENT OF JAMES L. LOGUE III, EXECUTIVE DIRECTOR,
MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY, DE-
TROIT, MI

Mr. LOGUE. Mr. Chairman, it's a pleasure to be here this morning.

After hearing the testimony from Secretary Cisneros and Assistant Secretary Retsinas, I find that most of my comments would be repetitive of many of the things they have said, something I am very pleased to hear. And in fact, I'm not surprised, frankly, knowing the quality of Nic, his having been one of my colleagues in the housing finance area for many years.

There are a few points I would like to amplify on that, but I think I can cut my already short comments even shorter, based on what I've heard today.

I would say I would support almost everything I've heard today with regard to the area of disposition.

With regard to disposition, HUD-owned properties impose blatant social and economic disruption in their communities. But because HFA's have financed and managed properties in the same neighborhoods as HUD, we have a tremendous stake in the success of HUD's disposition efforts.

The best approach toward troubled property is to prevent them from going into foreclosure in the first place. Successful portfolio management requires sufficient staffing, effective risk management, and approaching a project's needs comprehensively and creatively.

The HUD inventory has reached its current distress state in large part because HUD has not been able to meet these criteria.

I know Senator Dodd made a very important point today with regard to the issue of staffing and I would anticipate that the prospects for additional staffing at the HUD level in these areas is going to be severely limited.

But I think it's very important that the panel know that the problem with regard to staffing is serious. One piece of information I think will illustrate this problem.

The importance of managing and servicing its portfolio of multifamily loans is critical. HUD does not have the staff capacity to manage it. As an example, a recent audit by the HUD Inspector General's office found that the HUD multifamily loan servicing staff at the Detroit office are responsible for 105 projects each. That means that one staff person has to oversee 105 multifamily properties.

In comparison, my agency staff handle an average of sixteen multifamily properties per each individual. So you can see, just by this very simple piece of evidence, that the HUD staff is virtually overwhelmed by its own workload. And I understand that staff is not something that's going to be easy to come by, but it's something that has to be dealt with in an aggressive manner.

Aggressive risk management is critical to preventing losses. In Michigan, we closely monitor our entire multifamily inventory and take immediate corrective action when a property begins to show signs of distress.

A key factor in successful management is the ability to move quickly to correct problems.

My staff are not constrained by proscriptive regulations. They are expected to creatively put together the most effective package of solutions, subject to oversight by the agency's board of directors.

In contrast, HUD has stacks of handbooks delineating rigid procedures for action. Tied to these cumbersome handbooks, HUD is usually unable to take timely action to correct problems. HUD should be allowed to put systems into place which allow management creativity within reasonable guidelines, rather than proscriptive rigid procedures. If these steps fail and properties enter the inventory, HUD must move aggressively to return these properties to productive use.

Congress recognized the potential of an HFA-HUD partnership in HUD property disposition when it mandated HUD in 1987 to carry out a program to demonstrate the effectiveness of disposing of HUD-owned properties through HFA's.

Under this program, HUD is required to notify a participating HFA of HUD's plans to sell one of its properties, and provide the HFA with an option to purchase the property. HUD has indicated that it wants to move forward with this program, and we are encouraged by this, and will work closely with them to make it successful.

We've talked a lot about the section 8 issue with regard to property disposition. I would concur with the recommendations that were laid out by HUD with regard to solving this problem.

Senator Kerry hit the nail right on the head when he said that it's a problem of our own making. You can't expect HUD to be able to successfully dispose of these properties by having their hands tied through the lack of ability to foreclose. Without that ability, HUD really can't do anything.

We created the problem. I think we can resolve the problem, and I think it needs for us to take a completely new look at how we dispose of properties and re-figure out how we can meet both the needs of the tenants, low-income inhabitants of these units, and the needs to be fiscally responsible and get these properties out of the property disposition mode.

A few other points.

There's been mention today of the HFA-FHA risk sharing program. In last year's housing bill, this subcommittee responded to the scarcity of financing for multifamily housing and FHA's administrative difficulties by creating a risk-sharing program whereby HFA's and FHA would work together to support the financing of affordable housing.

This program will combine the power of FHA credit enhancement with the proven underwriting and long-term loan management capacity of qualified financially solid State agencies. We will be working closely with HUD to make this program a reality.

Another way HUD can facilitate the production of affordable housing is to substantially revise its subsidy layering guidelines, and delegate the review authority to State credit allocating agencies, as you mandated in last year's Housing Act. The existing subsidy layering review process is unnecessarily complicated and administratively unworkable.

We are heartened by HUD's indications that they are reviewing the concerns NCSHA and other organizations have expressed about

the latest draft of the guidelines, as well as on previous guidelines published and implemented by HUD. However, we are discouraged by reports that there are still questions about the constitutionality of the delegated review process, although we know HUD and the Department of Justice are reconsidering this issue.

The last issue I want to mention briefly is affordable housing preservation. I would like to comment on our ability to help HUD in assisting them in handling preservation transactions.

We believe that under the leadership of Secretary Cisneros, there's a new opportunity to make the preservation program work. And I can let you know that State agencies that are capable will be willing to participate with HUD in making sure preservation projects go through in a timely and efficient manner.

Senator SARBANES. Very good. Thank you, Mr. Logue.

Mr. Ratner, we'd be pleased to hear from you.

STATEMENT OF RONALD RATNER, PRESIDENT, FOREST CITY RESIDENTIAL DEVELOPMENT, INC., CLEVELAND, OH

Mr. RATNER. There have been so many interesting comments today that I was quickly trying to add a few notes to my remarks.

I am President of Forest City Residential Development, and Executive Vice President of Forest City Enterprises which are headquartered in Cleveland, OH.

Forest City is a publicly traded corporation with over \$2 billion in real estate holdings across the country. Our multifamily portfolio includes an ownership interest in over 32,000 apartment units in 18 States and over a 100 communities, ranking us as the 19th largest owner of multifamily real estate in the country.

As the Chairman stated, our participation in HUD and FHA programs began in the 1940's, in that case with the development and ownership of a section 608 property, and has continued through virtually every multifamily program.

We currently own 2,100 units in conventional, unsubsidized properties that are FHA insured, over 12,000 units in properties that receive Federal assistance, and over 4,000 units that are financed with tax-exempt bonds and include a 20 percent affordable component.

We are proud of our record of participation in HUD programs and the affordable housing in both conventional and assisted properties that we have built, own, manage or finance.

While representing only a third of our multifamily portfolio, these units are representative of our company's strong commitment in helping address both housing needs and urban issues.

Our multifamily portfolio is performing extremely well, but we have not been immune to the current crisis in our industry. Two properties, representing less than 2 percent of our portfolio, are troubled HUD insured assets.

I am honored to have been invited to participate on this panel. I'm also here today on behalf of the National Multi Housing Council, NMHC, and the National Apartment Association NAA. These two groups work closely together for an economic and governmental environment that supports quality, accessible and affordable rental housing.

I serve as a member of their Joint Legislative Committee. The members of these two associations own and manage about one-third of the Nation's 24 million rental housing units. Therefore, today, I speak from personal experience and frustration, as an industry spokesman and as a citizen concerned with a real threat to our national commitment to affordable multifamily housing.

On May 7, a special task force of the NMHC and NAA sent a letter to Secretary Cisneros, responding to his request for comments on the huge portfolio of troubled HUD properties. In that letter, we made several key points.

First, HUD's rigid application of handbook requirements has been creating needless cost to the taxpayers, deterioration of multifamily rental housing, and disruption to residents. HUD's historical tendency to avoid action will continue to increase defaults in coming months.

Second, this behavior conflicts with Congressional intent that HUD pursue the least costly reasonable alternative to further the goals of the National Housing Act.

Third, the Government could realize great savings with careful use of workouts and mortgage modification to restore project viability, and preserve low- and moderate-income housing.

Last, HUD should get out of the business of trying to administer growing inventories of troubled loans, by making these loans saleable into the secondary market, to institutions that are well-equipped to handle that task.

Our letter goes on to detail numerous technical recommendations. In reviewing that letter, prior to preparing my written testimony, I realized that we had identified a series of specific opportunities, but had stopped short of recommending a total structural change that would enable HUD to implement major alternatives in the way it does business.

My written testimony establishes some of the background that led to the current dilemma, and reiterates the necessity for positive workout procedures supported by aggressive foreclosures policies. This is the only way to prevent an onslaught of new defaults and a surge in the size of the HUD portfolio of properties and loans.

My conclusion, however, is that HUD—

Senator SARBANES. Would you repeat that observation? What is the way to prevent further defaults and growth in the HUD inventory?

Mr. RATNER. First, they have to establish a very workable workout program. They have to prevent foreclosures.

Second, they have to be able to proceed aggressively, in order to support that program, as was said this morning, with an assertive foreclosure policy that has teeth in it.

The two must absolutely necessary work together.

I'd like to add, actually, that I wanted to correct the record regarding the dynamics of the workout and foreclosure problem.

An owner of an FHA-insured property is subject to a regulatory agreement that clearly requires, under penalty of law, that big black box at the bottom of the page that says that the Government will come after you, that we all sign very, very carefully—that all income from operations be first used for operating expenses, and then be paid to the lender or HUD if the mortgage has been as-

signed. This would be applied to debt service. HUD must vigorously enforce these provisions.

Second, it is not only the lack of the foreclosure threat that creates workout gridlock. A responsible owner, managing an asset at the highest level permitted by the market, and willing to invest major capital, cannot even initiate a workable workout discussion under HUD's current policies and programs.

There are many details we've provided in our letter, but suffice it to say that it is virtually impossible under today's programs for a property that is having any significant distress to find an alternative in HUD's workout program. They simply aren't capable of doing that.

There's also, by the way, a simple vehicle for HUD to discover potentially troubled assets. Responsible owners with substantial investment in an asset will seek help, but today, there's no one to talk to.

In regard to one of our own properties, we have a \$22 million loan, we've invested over \$8 million and are operating the property at above market rents, below market expenses, and generally considered by even HUD—to be doing an excellent job. We are also funding the current deficit. However, we've been told that we cannot even discuss relief provisions or a workout without first defaulting on the mortgage.

This is the other side of Senator Kerry's catch-22. There are a lot of responsible owners, there are a lot of people who realize that the property has suffered from the dilemmas of the 1980's, but who simply have nobody at home to talk to when it comes to trying to find a way to prevent defaults.

I recommend that we consider a major shift in resource allocation and a clean break with existing policies and regulations. Some of the examples I just gave show that it's basically impossible for HUD, within its current structure, to find appropriate means to deal with a crises of the proportion that it faces.

I propose the creation of an independent recovery bank within HUD. This would be modeled after the good-bank, bad-bank structure successfully utilized by other lenders to deal with their troubled portfolios.

The goal of this process would be to shift responsibility for the HUD-held and troubled loan inventory to a new group of actors with a mandate to create new policies and programs appropriate to the challenge.

The senior executives responsible for the recovery bank's activities would have a limited time to report to the Congressional Oversight Committee on the programs and policies required to quickly and fairly dispose of the assets.

In many ways, the recovery bank would function like the RTC and would be a self-liquidating organization. The entity would be able to take actions, such as:

The establishment of a program to monitor troubled loans and identify projects that should be targeted for workouts prior to default. I've heard the Secretary and the Assistant Secretary talk about their initiatives to do that. I noticed that they decided that a lot of that would have to be out-sourced because the Department

didn't have the staff to do this effectively. This is one of the reasons why a separately created entity would be effective.

The creation of a rational workout and aggressive foreclosure and sale policy in line with my prior discussion and described in detail in our letter to Secretary Cisneros.

Bulk sale, where feasible, of non-performing loans and restructured performing components of assigned or troubled loans.

Evenhanded treatment of coinsured loans. There's been a lot of discussion about the coinsured program this morning, and it was, by everybody's admission, a complete disaster. It harmed tenants, it harmed the industry, it harmed the Government, and particularly it has set us back in all of our efforts to create affordable housing. But in an attempt to distance itself from this massively flawed initiative, the previous administration applied a rigid policy of willful neglect to previously coinsured loans.

Simple relief provisions, such as temporarily waiving fees, replacement reserve deposits, or principal payments are routinely granted for fully insured projects, and not even considered for a coinsured loan. A coinsured loan should not condemn a property, it's owners, tenants or neighborhood to a life in administrative purgatory.

The workout/foreclosure program I have recommended should be appropriately applied to coinsured loans. This is very simple, and any other approach results in self-inflicted wounds for HUD and the Insurance Fund.

A loss by any other name is still a loss.

HUD should consider reissuing mortgage insurance. The Assistant Secretary I believe referred to this in his comments this morning—that defaulted 3 years ago at a 10 percent rate are in effect performing loans at today's rate of 7.5 percent. Again, through a very complex bureaucratic catch 22, it's impossible for HUD to re-issue these as performing loan.

The owner builds up an additional accrual at the 10 percent rate, and the property sits in legislative limbo. You can't get it out, you can't deal with it, it is bound ultimately to go into foreclosure.

Today's low rate market creates a financing window which can tremendously mitigate HUD's loss.

HUD should also carefully consider floating rate alternatives in light of today's steep yield curve.

I'll pass over the comments that I had in my written testimony on the way the current low-income housing program works, as far as the mechanism to preserve low-income housing opportunities.

I might add, and I think that this was the comment that was made this morning, that in a lot of cases, market forces simply dictate that a low-income housing project will stay low-income without elaborate mechanisms.

The devaluation of real estate and reduction in rents has itself created new affordable housing. In those cases, as was said this morning, I don't think we need to apply very expensive project-based section 8.

In other cases, the asset is truly blighted. I've visited some of these, and looked at purchasing them. I would not want to own them in my portfolio because they are fated to be substandard housing. We should simply consider demolishing these properties.

Very easy to say, very, very hard to do. In these cases I would of course recommend tenant-based section 8 to provide for the continued housing needs of the low-income tenants in these units. These and many other strategies can be used to resolve the problem.

It is time to put the financial failures of the 1980's behind while paying close attention to their lessons. We must proceed to allow our financial institutions, led by Secretary Cisneros and HUD, to provide new sources of capital for low- and moderate-income housing.

The idea of the recovery bank to deal aggressively with this problem, I think would tremendously free HUD to go about its other efforts.

Senator SARBANES. Thank you very much, sir.

Mr. Retsinas, I would like to ask you first, what are the assumptions that lie behind this estimate of an \$11.9 billion in potential losses to HUD?

Mr. RETSINAS. That estimate was derived, as I said earlier, as a result of the audit. In undertaking the audit, Price Waterhouse, which was the auditor on behalf of the HUD Inspector General, said that it would not be able to issue a clean opinion until it had accurate information on the multifamily portfolio.

Because of that, the Department engaged Coopers and Lybrand. Coopers and Lybrand did, as we discussed earlier, the risk-based analysis. It looked at a number of factors under a model, a computer-based model that it developed. It looked at vacancy rate, it looked at cash flow, it looked at the condition of the property. Based on the conversions of a variety of those factors, it categorized the loans and the projects in various categories.

As a result of that categorization, it was their judgment—with some refinements—but essentially their judgment that the loan loss reserve had to be increased. And as a result, the cumulative loan loss reserve on the balance sheet would be \$11.9 billion. It was a result of a large survey of about 17,065 projects in the portfolio.

Senator SARBANES. What is the assumption as to what will happen to those projects?

Mr. RETSINAS. The assumption is, it varies of course by project. A good percentage of them will default over time and therefore that default is a potential claim and loss to the Federal Government.

Senator SARBANES. And how those costs estimated? What do they assume you will do with the project, once it defaults?

Mr. RETSINAS. It is a net of the claim to be paid less the estimated proceeds from the disposition of the property based on historical experience of the FHA.

Senator SARBANES. OK. So the estimate in effect looks at a property all the way through the chain of events and assumes that you will dispose of it in one way or another for a certain return, and then nets that out against the overall obligation you've assumed for it. Is that right?

Mr. RETSINAS. Yes. And it does include in that a discount for that return. It is anticipated that there would be a loss.

Senator SARBANES. Is the disposition estimate a conservatively calculated one? I mean do you think you might in fact do better?

Or worse? Or is it fairly realistic? Or do you have no way of knowing?

Mr. RETSINAS. Well,—

Senator SARBANES. You must know, otherwise you couldn't evaluate as to whether the estimate has any realism to it.

Mr. RETSINAS. We accepted the audit. And by the acceptance of the audit, we concur with the conclusion. The assumptions are conservative but we accept the audit.

We, of course, have no way of knowing what the interest rate will be for what the economy will be like, but we think it is a reasonable estimate. We need to take whatever steps we can, as we have outlined, and some of the suggestions we have outlined are ways to mitigate or to reduce that loss.

Senator SARBANES. Now let me ask the panel members, anyone who wants to respond to this question.

It was suggested earlier in some testimony or comments that if the section 8 vouchers were fully funded, which is not I don't think within the world of realism, but just for the sake of a question, if section 8 subsidies were fully funded, these problems could be worked out fairly simply, as I understood it. Is that correct? I mean, do you all agree with that?

Mr. GROW. I'll take the first hack at it.

Senator SARBANES. A \$3 billion figure was used.

Mr. GROW. The section 8 subsidies were funded, remember, we're talking, when we say \$3 billion, we're talking 15-year contract authority for that section 8 contract.

The reason we're talking, at the moment, 15-year contract authority is that many of these buildings need substantial rehabilitation. And lenders, typically without FHA insurance, wouldn't loan on only a 5-year subsidy commitment.

You could, you know, you could play games with the amount of budget authority you need by shifting the contract term back to 5 years, so long as you were willing to provide other forms of credit enhancement, like FHA insurance, to enable lenders to make the loan.

Senator SARBANES. Is 15 years the minimum time that's necessary to bring lenders in, or could it be done—I understand you think 5 years is too short—in a shorter period of time, somewhere in between?

Mr. GROW. I'd throw that into Jim or Alan's lap. I think you could go shorter than 15, but I'm not a lender, a risk-taker.

Mr. LOGUE. As a lender, Michigan financed over \$1.5 billion worth of multifamily housing over the 20 years Michigan State Authority's been in existence.

I would say that from the perspective of financing today, a 15-year contract authority would be a workable mechanism for us in Michigan to finance multifamily housing.

Now, I couldn't say that would be the case for all areas of the country or for all State housing finance agencies across the country. However, we have financed, in fact, within the last 5 years, a number of projects that received 15-year contract authority with 30-year tax exempt bonds, was something we felt we could justify as far as an underwriting risk. You obviously have an exposure

which begins in the 16th year with regard to what happens to that housing when the subsidy disappears.

But certainly from Michigan's standpoint, and I would say probably from the perspective of a dozen or so other large States that have an extensive multifamily history and financing capacity, fifteen years would be something that we could use to finance off of.

The other way to do it, as you—

Senator SARBANES. Could you do it with a shorter, for example, 12 years subsidy?

Mr. LOGUE. I would say we'd have to look at the specifics of the particular transaction. I think 15 years would be, I would consider pretty close to the minimum term you'd have to have.

Senator SARBANES. Yes, Mr. Ratner.

Mr. RATNER. One comment I wanted to make on that is that while we've not attempted to do financing of a new project with 15-year section 8, we've very recently, in fact, we're currently in the private market, not supported by a State agency, attempting to re-finance a section 8 project with 15 years left on the original section 8 commitment, and we're basically unable to finance that in the current private market.

So while I think it's possible that either with State agency intervention or FHA intervention, a 15-year commitment would be sufficient, I think you have to realize that it's going to require that secondary piggyback of assistance. The private market today simply will not finance a property that has a 15-year section 8 unless you're also trying to do a 15-year self-amortizing loan, which is pretty tough to do.

Senator SARBANES. What if you weren't going to get the \$3 billion. If the budget constraints were such that that's not in the ball park, what can HUD do to move this process along?

Mr. GROW. May I take the first response?

If you're really interested in protecting the people who live in the formerly subsidized projects, let's talk about that category of projects for the moment, the people who are generally 50 percent of median income and less, there are very few gimmicks that HUD could engage in without subsidy to dispose of those properties and still meet the housing needs of those people.

Their incomes are just so low that typically they can only afford operating costs, no debt for acquisition or rehab and, in many cases, not even operating costs. So the subsidy is, as a practical matter, required if you're going to protect the tenants, which I think I've seen Congress, over the last decade, reaffirm that commitment.

I heard HUD reaffirm it today.

Shifting to a tenant based subsidy, a section 8 certificate really doesn't save you any money, because the annual budget authority required for that certificate, even though it's only 5 years, is something that's really only about 10 to 20 percent less than a property disposition section 8 subsidy, which carries the added advantage of ensuring that there's going to be a rehabilitated unit available to the family.

Mr. CRAVITZ. I think a section 8 subsidy is the most expensive subsidy I think we can really talk about. And even though I don't disagree with what Jim was saying, I think there are many other

tools that would be available to at least minimize the section 8 requirement for these projects. Some of these are ideas that HUD has already started to think about and, in some cases, implement. No. 1, is projects can be sold to non-profit groups or not-for-profit joint ventures with profit motivated developers for \$1.

No. 2, HUD could redirect HOME funds, which have not been used that quickly until now, to fund 100 percent of any rehab cost and any reserves that are necessary upon sale of properties.

Basically I'm saying that we're going to give the property away and we're going to give someone money to rehab it, so now we get back to Jim Grow's problem of the only thing the tenant really needs to worry about is paying enough rent to operate the property.

At that point we're talking about rent levels probably in the \$300 to maybe \$400 a month range. It varies probably widely for different parts of the country, but I would use that number.

Now, we can talk about section 8 rent subsidies at that level, a level of \$300 or \$400 a month for those very low-income tenants who really can't afford to pay that rent. For other tenants who can afford to pay the \$300 to \$400 a month rent there really is no need for any additional section 8 subsidy.

I think if you ran out numbers, and unfortunately, I don't have a lot of examples of the properties in HUD's current inventory, but if you ran out examples of the cost of that program, that is grants or loans repayable upon sale as well as selling properties for \$1, I think you'd find it to be much, much less expensive than this ongoing obligation to fund section 8 which is an obligation that whether HUD says it would be for 5 years or 15 years, I think everyone recognizes it's really an obligation that probably goes on for the life of the entire property.

There are other combinations.

We talk about the use of low-income housing tax credits as another source of funds to rehabilitate or acquire HUD low-income or subsidized property disposition projects. I think it would help to seek real estate tax relief from municipalities in which these projects are located. I know, in Chicago, the single largest expense item are real estate taxes on these projects.

If there's some way HUD could get relief from municipalities that would play a significant role in reducing rents that need to be charged. There's a whole sort of list of things with section 8 used in some cases.

Senator SARBANES. That's an interesting observation.

Let me take a couple of comments.

Mr. Retsinas, did you want to respond to that?

I'm going to have to excuse myself shortly to go up to the Budget Committee to vote for the reconciliation bill so we can move the President's economic package forward, which includes within it, actually, a permanent extension of the low-income housing tax credit, as a matter of fact.

Mr. RETSINAS. And I would urge you God speed on that.

[Laughter.]

Mr. RETSINAS. The only comment is that Mr. Cravitz was right. There's no one solution. Section 8 can be an expensive subsidy. The difficulty is there is a dearth of other alternatives.

We do not have large-scale capital grant programs, for example. As a matter of fact, we have come before your colleagues and asked for some increased appropriations for other kinds of programs, but that's been difficult in this budget environment. So, in some cases, section 8 becomes the only alternative available to use.

Senator SARBANES. I'll take Mr. Logue, and Mr. Ratner, then I'm going to have to draw this to a close.

Mr. LOGUE. Thank you, Mr. Chairman.

On that point, I would disagree with Mr. Cravitz on one point in particular, and that has to do with the HOME funding. I would suggest, contrary to his comment, that the HOME funds are being spent. I administer, in our State, about \$30 million worth of HOME funds, and I can tell you, our HOME funding is going out. I don't think the HOME funding program is designed to meet this problem. That would be a serious mistake for an otherwise good program.

I would concur with Nic's comments that there really aren't many alternatives HUD has unless there are changes to the fundamental structure of how section 8 is counted as far as its budget implications. I think that may be something that should be considered and to have them have some of the prescriptions that they have, which don't allow them to move forward, remove them by law, if necessary.

But I think you either insure the mortgage or for the long-term redefine how you calculate or budget section 8. Or you remove section 8 from the equation altogether and let the properties go out on a market rate basis, which I think, in many instances, may not be the way you would want to go on 100 percent of it.

Senator SARBANES. I guess Senator D'Amato's idea was that if you did a mix of that, you could produce some money which covers you on your subsidized element.

Mr. LOGUE. I would agree with that. I think that HUD needs as much flexibility.

Senator SARBANES. It costs you some units, but in the overall, it might advance you. However, you'd be very concerned about that, wouldn't you, Mr. Grow?

Mr. GROW. Well, yes. As I pointed out, already 60 percent of these units are already not being preserved.

Senator SARBANES. Mr. Ratner.

Mr. RATNER. One comment I wanted to make is that really there is no such thing as low-cost housing. There's in effect only low-rent housing. Good quality safe housing is not inexpensive to operate and to own.

The operating costs, as Jim said, of an apartment project pretty much typically across the country would be in the neighborhood of \$300 a month. If a tenant can't afford to pay that, you have to have some level of subsidy. And what's very important, and the key point I want to make, is that you can't have a static subsidy. The benefit of the section 8 program is that it is a dynamic subsidy.

The problem, the major reason you have a lot of the defaults, is not that these were necessarily badly underwritten or badly managed properties, but that these are properties that were put into play 15, 20, 30 years ago with static subsidies.

As the operating costs increased, the tenants' income, because these are low-income tenants, did not increase along with inflation. They simply fell short. No matter how you manage the buildings, no matter how you operate, you can't continue with a tenant who only has 20 percent more income and try to deal with a property that has 100 percent more operating costs.

I'm very worried that if we don't provide realistic subsidy programs, what you're going to do is create another whole round of defaults in another 10 years, when in fact that basic rule of low-income housing, takes over again.

You can't get away from it. That basic rule is going to take over and cause another whole round of defaults no matter who owns, no matter who operates, no matter how well done, non-profit, for-profit, State agency, you can't get away from it. The fundamental rule of housing will apply.

Senator SARBANES. Well, gentlemen, thank you very much. It's been a very helpful panel. We appreciate it.

The committee stands adjourned.

[Whereupon, at 12:35 p.m., Tuesday, June 22, 1993, the committee was adjourned, subject to call of the chair.]

[Prepared statements, response to written questions and additional material supplied for the record follow:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

I would like to commend my colleague Senator Sarbanes for conducting this hearing on the issues surrounding our Nation's Multifamily Housing. I would also like to welcome Secretary Cisneros to the subcommittee. I look forward to hearing his testimony and ideas on how we can ensure the continued availability of low and moderate multifamily housing while securing the financial stability of the Federal Housing Administration.

The need for affordable housing is undeniable. All Americans deserve a decent place to live. For 59 years the FHA program has been an essential element in helping low- and moderate-income people experience this opportunity. In order for this opportunity to continue to exist the FHA program must be able to fulfill its mission while remaining financially sound.

HUD owns an inventory of 187 multifamily properties with 31,500 units and this inventory is growing rapidly. HUD's ownership of this inventory incurs significant costs. Holding costs for fiscal year 1992 alone totalled \$248 million or approximately \$8,267 per unit. Approximately 31 percent of the current inventory is in poor physical condition. Such deterioration creates an unsuitable living environment for existing tenants, drives down property values in surrounding neighborhoods, and wastes assets that could provide decent affordable housing.

HUD is essentially administering a subsidized housing program out of the FHA's General Insurance Fund. A disposition plan that will balance the need for affordable housing is far overdue. HUD and Congress must work together to develop a plan that will provide the needed flexibility and innovation to dispose of the current inventory while addressing our communities housing needs.

According to a recent study by Coopers & Lybrand, the Department of Housing and Urban Development is at risk of losing as much as \$11.9 billion as hundreds of apartment building owners default on their mortgages. As troubling as that figure may be, it is even more troubling that the cost of this fiasco would be borne primarily by the American taxpayer.

For several years, HUD's information about its multifamily mortgage insurance fund has been inadequate and inaccurate. HUD investigators have attributed this dilemma to staff shortages and a lack of enough accurate information about the status of loans.

I stress the importance of maintaining the actuarial soundness of the FHA Insurance Fund while balancing the need for providing affordable housing opportunities. Without the FHA program millions of Americans would be denied access to affordable housing. We must work to make the FHA multifamily program healthy before it is too late.

STATEMENT OF SENATOR CHRISTOPHER S. BOND

Mr. Chairman, thank you for calling this hearing today. I consider the issues and requirements relating to the disposition of HUD-owned multifamily housing among the most significant issues facing the Congress and the Housing Subcommittee during the 103rd Congress. HUD Secretary Cisneros has on several occasions identified HUD's Multifamily Housing Property Disposition Program as an area of significant concern to the Department and high on its legislative agenda for reform. Moreover, the HUD Inspector General has also identified the management and disposition of HUD's multifamily housing inventory as one of the most deficient program areas in the Department.

HUD has indicated that the Multifamily Housing Property Disposition Program is very costly to the Department and that Section 203 of the Housing and Community Development Amendments of 1978 limits severely the ability of HUD to effectively and efficiently dispose of properties in its multifamily housing property disposition inventory. In particular, as of April 1, 1993, HUD owned approximately 189 multifamily housing projects (31,652 units) and was mortgagee-in-possession for approximately 102 other multifamily housing projects (15,667 units). Moreover, as of April 1, there were approximately 287 multifamily housing projects (42,738 units) in the pipeline awaiting possible foreclosure by HUD.

Section 203 of 1978 Amendments, in general, requires HUD to maintain the low-income character of units in projects in HUD's Multifamily Housing Property Disposition Program; meaning that these units have to be maintained for households whose income does not exceed 80 percent of area median income and that these households may not pay more than 30 percent of their adjusted income for rent. For subsidized or formerly subsidized projects, all units must be maintained as low-income for a period of not less than 15 years. For all other projects, in general, all units that are occupied by low-income persons must be maintained as low-income

for a period of not less than 15 years, except that certificates and vouchers may be provided to all low-income families where HUD determines there is available in the area an adequate supply of habitable affordable housing for low-income families.

As a practical matter, HUD has construed Section 203 of the 1978 Amendments to require HUD to provide 15-year project-based Section 8 assistance for most of the units in housing projects held by HUD in its multifamily housing inventory. However, HUD has budget authority of only \$93 million for FY 93 for 15-year Section 8 assistance. This is not nearly enough to cover all the units subject to the requirements of Section 203, leaving HUD as a landlord without the capacity to dispose of properties in its multifamily housing inventory.

I understand that HUD estimates currently that it would cost as much as \$3 billion in 15-year Section 8 project-based assistance to dispose of its current multifamily housing inventory. Moreover, HUD's multifamily housing inventory is expected to increase significantly so that the expected cost in 15-year Section 8 project-based assistance for multifamily housing disposition could rise to as much as \$10 billion over the next several years. These costs do not include the other costs that HUD may incur, such as the costs of maintenance, rehabilitation, and management. I am very troubled by these costs. This means that HUD has become essentially a Federal public housing agency which pays for its low-income housing subsidies out of the FHA General Insurance Fund. I want to be clear that the FHA General Insurance Fund was never intended to operate as a low-income housing subsidy program. This is particularly troubling since the FHA General Insurance Fund is mandatory spending as opposed to discretionary spending, such as required under the Section 8 program. Moreover, HUD has not proven to be a very good landlord and many of the projects are beginning to fall into disrepair.

Section 203 does permit HUD to discount the price of a multifamily housing property for sale to a purchaser to take into account the costs which would be incurred by an owner in maintaining the low-income character of a unit for 15 years. However, I understand that HUD has been reluctant to employ this approach because it is difficult administratively to ensure that units are being maintained as low-income for 15 years. I strongly urge HUD to explore this option as a way of disposing of multifamily housing properties and getting them into the hands of nonprofits and private entities.

Finally, I want to thank Secretary Cisneros for his interest and efforts in finding solutions to the disposition of HUD-owned multifamily housing. In particular, the city of St. Louis has a multifamily housing project known as LaClede Town which is located in the heart of midtown St. Louis. This 1240-unit project is occupied by some 200 families and is in the most deplorable physical condition imaginable. LaClede Town is not only in the most serious physical distress, but drug-related and other crime is rampant and spills over into the contiguous neighborhoods. I place a high priority on finding a solution to the disposition of LaClede Town, and I am very happy that HUD and local officials are currently negotiating a way to dispose of this property. I emphasize that local solutions need to be part of the mix. I also hope that the final disposition of LaClede Town can help to serve as a model for how HUD can address the disposition of certain multifamily housing projects that are clearly beyond rehabilitation and which drag down the rest of a community.

I want to thank the witnesses today for providing valuable and insightful testimony on these very important issues. I plan to examine their concerns and recommendations closely. Again, I consider the issues related to the disposition of HUD-owned multifamily housing a major concern and one which Congress must address. We need to find creative solutions to these problems. We also need to get HUD out of the landlord business.

I also believe that Congress needs to reexamine the Federal policies, as a whole, with regard to FHA-insured and HUD-assisted properties. In other words, my concerns run deeper than just housing disposition and preservation policies. I am also concerned with Federal policies with regard to the supply of available and affordable multifamily housing, underwriting standards, how the Federal multifamily housing stock is maintained, and other issues. These policies and procedures are key to the ability of the Federal Government to ensure the continued availability and affordability of low- and moderate-income multifamily housing.

Thank you again, Mr. Chairman, for this timely and important hearing.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Thank you very much, Chairman Sarbanes.

This hearing on multifamily housing issues comes at a critical time. We continue to face a dramatic shortage in affordable rental housing and that shortage has hurt many families who are struggling to make a better life.

The Enterprise Foundation reports that about 60 percent of families at the poverty level pay at least half of their income on rent. Certainly, with housing costs taking that kind of a bite out of the family budget it becomes very difficult to make ends meet. Furthermore, a family paying 50 percent of its income on rent will have a difficult time realizing the dream of homeownership.

Regrettably, at a time when we need to stimulate the multifamily housing market, the Federal multifamily programs are facing huge losses. Reports from the HUD Inspector General's Office and two accounting firms suggest that, in the next few years, HUD could lose up to \$12 billion on federally insured multifamily mortgages.

In relative terms, there are few troubled properties in my home State of Connecticut. Currently, HUD owns two properties in the State and has foreclosed on six others. Nonetheless, there are a substantial number of tenants who live in those properties and they deserve housing that is properly managed.

I am also concerned about the costs that will be borne by Connecticut taxpayers. We need to find cost-effective solutions to this problem so that we can minimize the tax burden on our citizens. We can not afford to throw good money after bad. But at the same time, we must find ways to increase the production of multifamily housing. This will not be an easy task and there are no easy answers. But at least this hearing will help get the process moving.

And as we discuss potential solutions today, we ought to be absolutely clear about one thing—this is a problem that Secretary Cisneros inherited. In the past, during the Reagan years particularly, there was substantial mismanagement and some outright corruption at HUD. The agency must get past these problems as quickly as possible and restore the confidence of the American people in this program. But we ought not to be surprised if that process takes a certain amount of time.

I am pleased that we have Secretary Cisneros with us today, and I look forward to hearing his proposals for improving the way in which HUD manages its multifamily portfolio. Additionally, I know that our other distinguished witnesses will have some interesting ideas concerning the best ways to strengthen the Federal multifamily housing programs and I look forward to their testimony as well.

Thank you very much.

**STATEMENT BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS**

Washington, D.C.
June 22, 1993



by

SECRETARY HENRY G. CISNEROS

STATEMENT OF HENRY G. CISNEROS
SECRETARY OF HOUSING AND URBAN DEVELOPMENT

Mr. Chairman and Members of the committee: Thank you for the opportunity to discuss with you today the single largest problem I have inherited at the department—the management and disposition of HUD's multifamily inventory.

The problem is complex and has many dimensions. On one level, it is an operational problem. There has been phenomenal growth in the numbers of properties that are owned—or are about to be owned—by the Department. The Department also holds increasing numbers of formerly insured mortgages that have come into our inventory after default. Still other insured mortgages are at risk of default. The capacity of the Department to manage all this—to sell properties, to mitigate losses once defaults occur, to avert defaults—is at question.

On another level, it is a money issue. Preserving the affordability of foreclosed and HUD-owned properties will be costly—whether or not we loosen legislative restrictions. Insurance claims, as Sunday's New York Times article concluded, could run in the billions.

On still another level, it is an affordable housing issue. Many of the properties were designed to serve—and do serve—low and moderate income families. In many jurisdictions, this housing is a resource that must be preserved.

On a final level, it is a neighborhood issue. HUD's management of its own inventory has been abysmal. The physical condition of many properties are deteriorating; others have been overrun by drug trafficking and crime. The truth is stark: HUD has in many cases exacerbated the declining quality of life in urban America.

As you know, the problem is not new. Since the mid-1980's this Committee and others have held numerous hearings on the multifamily inventory. Those hearings outlined the basic causes of HUD's dilemma—some partly within HUD's control (the poor design of the coinsurance program, faulty underwriting, the absence of sufficient monitoring, the lack of adequate staff resources)—some clearly outside HUD's control (the downturn in regional rental markets, the impact of tax reform).

What is new is the extent of the problem. Congressional mandates for FHA audits have appropriately required the Department to significantly upgrade its information systems and acknowledge the depth and severity of the problem.

My testimony this morning is intended to do three things: to outline the nature and scope of the problem, to explain how and why we got here and to outline an aggressive action plan—legislative, administrative, budgetary—for resolving all aspects of what can safely be called "HUD's multifamily crisis".

Mr. Chairman, you and other Members of this committee can be assured that resolving this crisis has my highest priority. Fortunately, I have in Nic Retsinas an FHA Commissioner with the qualifications and skill to lead this effort.

But resolving this problem will require a high level of political will and commitment—both within the administration and Congress. It will require legislative relief—this year—that not all constituency groups will like. It will require changes in how my Department runs—that will shake up the existing civil service. It will most importantly require a level of accountability that all too often is rare in government.

STATEMENT OF THE PROBLEM

HUD's multifamily problem has three main components. First, there has been phenomenal growth in the numbers of properties that are owned—or are about to be owned—by the Department. Second, the Department also holds increasing numbers of formerly insured mortgages that have been assigned after default. And finally, a substantial portion of other insured mortgages are at risk of default.

The first chart spells out the relative size of each part of the problem. As you can see, the inventories of HUD-assigned mortgages and HUD-owned properties are large and growing. At the end of FY 1992, out of nearly 18,000 active FHA mortgages and projects, 14 percent were HUD-assigned projects and one percent were HUD-owned.

Problem One: The HUD-Owned Inventory

Let me explain each part of the problem in greater detail both in terms of size and origin. First, the properties that HUD owns or is about to own. The chart before you shows the growth in the HUD-owned inventory, which totalled 170 projects—about 29,000 units—at the end of FY 1992. This is an increase, by more than 100, of projects owned by HUD at the end of FY 1988.

The arithmetic reflects a simple truth: HUD has acquired projects much more rapidly than it has been able to sell them. HUD acquired 72 projects in FY 1991 and sold 11; it acquired 67 projects in FY 1992 and sold 27.

How this happened is directly attributable to two factors: restrictive statutes governing property disposition and the failure of previous Administrations to request sufficient funding to carry out the legislative mandate. Let me be specific.

The Housing and Development Act of 1987 directs HUD to sell projects at foreclosure sale and from inventory in a manner that preserves them as affordable housing. The legislation requires that expensive subsidies—15 year project-based rental assistance—be used to achieve the affordability objective.

Previous Administrations opposed these legislative restrictions and refused to ask for the level of funding needed to carry them out. Thus funding to assist the sale of properties has not been realistic and has not kept pace with inventory growth. For example, HUD received a total of \$96 million in Section 8 budget authority for property disposition in FY 1993—enough to fund 15-year Section 8 contracts for approximately 1,100 units.

The result is disposition gridlock. Properties owned by HUD simply cannot be sold expeditiously and thus sit in the inventory for an average of three and one-half years.

Yet HUD is not organized to manage and rehabilitate projects. Time and again, Inspector General reports have found that HUD lacks adequate staff to manage properties and prepare them for sale.

HUD incurs substantial holding costs to maintain projects in inventory. It costs the government about \$14 per unit per day to maintain formerly subsidized properties. A recent Government Accounting Office study of the multifamily property disposition inventory found that HUD incurred holding costs of about \$254 million in FY 1992. This figure represents the difference between property revenue—largely from rents—and expenses for operating, such as maintenance, taxes, utilities, and interest on borrowed funds.

In addition, GAO adds \$5.8 million annually for the salaries of the HUD staff managing the inventory. These holding costs, paid for out of the FHA's General Insurance Fund, essentially substitute for directly appropriated subsidies which would be required by law in order to maintain the low-income tenancy of the projects if they were sold.

Problem Two: HUD-Held Mortgages

The second part of HUD's multifamily crisis is the HUD-held, as distinguished from the HUD-owned, inventory.

As I stated before, the inventory of HUD-assigned mortgages is large and growing. At the end of FY 1992, HUD held nearly 2,500 mortgages, an increase of about 1,000 mortgages over the number held in 1988.

With the growing number of HUD-held mortgages, you can see that the share of delinquent mortgages also increased. At the end of FY 1992, more than half of the HUD-assigned mortgages were delinquent mortgages, compared to 33 percent in FY 1988. A total of 266 mortgages—about 41,000 units—were in foreclosure. In recent years, HUD has sold to third parties about half of the projects taken to foreclosure sale and acquired the remainder.

A number of factors led to the growth in this portion of the inventory. The multifamily stock was impacted by the adverse economic and tax consequences of the 1980's housing recession and the 1986 Tax Reform Act.

Significant downturns affected regional economies, putting severe pressure on local housing markets. In this environment, loose lending practices and underwriting mistakes through the coinsurance program exacerbated a difficult market.

Tax benefits lost to subsidized projects (and multifamily projects in general) led to financial distress in some cases and to disinvestment in others. In addition, the projects were aging and showing the economic and physical wear and tear of years of use. These projects lacked the financial means or mechanisms to refurbish the physical plant.

Problem Three: The Insured Inventory

The third part of HUD's multifamily crisis is the at-risk FHA-insured inventory. Currently, FHA has \$43 billion of multifamily insurance-in-force. Fully 27 percent of that amount—about \$12 billion—is at risk of default.

The same things that led to the defaulted inventory have led to this at-risk insured inventory: the economic downturn affected properties in the FHA portfolio (as well as the private market); flawed program design and implementation (e.g., coinsurance) led to problem loans; and faulty underwriting by HUD led to bad loans insured by FHA.

WHAT DO WE DO

It bears stressing that this problem evolved over many years. It will take concerted effort, additional resources, and many years to resolve it.

For the property disposition problem, we need legislative action this year. In many respects, the current law is too rigid and unnecessarily adds to the cost of the process. The legislation we intend to seek will increase our ability to deal with the subsidized and unsubsidized stock in a reasonable and cost-effective manner.

- We propose revising the subsidy treatment for a small portion of the subsidized and formerly subsidized projects to provide some flexibility which would allow us to create a better income mix.

- Protecting units and tenants receiving project-based rental assistance in unsubsidized or formerly unsubsidized projects by providing five year project-based renewable Section 8 assistance. This approach will ensure that such tenants will not be adversely affected by sale of the project and will allow HUD to retain the ability to sell projects on the private market for market rate mixed rental use.

- Proposing a new approach that recognizes the current mandatory nature of the affordable housing provisions for those units where a mandatory subsidy is necessary to preserve affordability for previously subsidized units.

- Providing greater flexibility for the department to respond to individualized conditions, such as the existence of soft markets, the need for other forms of subsidy, or the potential for low incomes uses which are non-rental, such as low-income homeownership or homeless shelter.

- Working more productively with state and local governments by consulting with them early in the process and involving them in development of disposition strategies.

While the solutions required for HUD's property disposition problem are largely legislative, we must also address the need for increased financial resources. To that end, we have begun talks with the GSEs, state and local governments, and financial advisers on ways to access capital to finance the disposition of our inventory. HUD, for example, will enter into innovative risk-sharing arrangements with state and local housing finance agencies. We are also investigating refinancing of developments that will improve the financial condition of many of our properties.

Addressing the property disposition issue is critical and an especially challenging task in an environment of continually declining resources; but we must also address the issue of HUD-held mortgages and those about to default.

This will require two types of largely administrative actions: those to mitigate losses once defaults occur and those to prevent defaults. Some of these actions we have recently implemented; others we are currently pursuing. I want to describe these actions for you now.

- We have established a Loss Mitigation Committee and a work plan to reduce losses.

- We are instituting an "early warning system" which includes automating the collection and analysis of project financial statements so we can rapidly identify problem trends.

- We already initiated field staff training to expand skill levels.

- We are in the process of drafting aggressive, yet flexible, work-out strategies.

- We will pursue delegation of servicing responsibility to others, such as Housing Finance Agencies, to reduce servicing ratios and compensate for continuing staff reductions. We are currently using loan servicing contracts to manage the formerly coinsured loan portfolio.

- To take advantage of the market, we are pursuing streamlined refinancing strategies.

- We are in the process of revising our flexible subsidy regulations to make this program more attractive to owners.

- Finally, we are currently conducting training for certification of HUD appraisers to better ascertain property values in designing project work-outs.

However, even with these enhancements to our loan servicing and foreclosure prevention efforts, I must caution you that we do not believe that they alone will solve the problem of managing and disposing of the portfolio.

CURRENT COURSE—WHAT HAPPENS IF WE DO NOTHING

While we will work to prevent foreclosures and an increased disposition problem through improved loan management and servicing, we already face an enormous property disposition problem with a long and difficult history. I would like to discuss our current course of action and what happens if we do nothing to change our disposition actions.

On our current course, the inventory will continue to increase as the number of foreclosures exceeds our ability to sell the properties. HUD will be required to own, manage, and preserve the inventory as a source of affordable rental housing—a task which everyone agrees we are not equipped to handle efficiently.

The cost of subsidizing the inventory will continue as a mandatory expenditure under the FHA Fund. Whether HUD holds the inventory and continues to use the FHA as an indirect subsidy mechanism, or returns the stock to the private sector and uses a more direct subsidy mechanism such as Section 8, the Federal Government will bear the costs. Whether we choose to highlight the costs under the Section 8 program or disguise it as mandatory FHA spending, we are already spending the money. Spending is not at issue here. The issue is the appropriate means for spending to preserve and protect the stock and whether HUD or the private sector is better equipped to repair, manage, and own the properties.

While savings can be achieved by fine-tuning current requirements, the spending decisions, in large measure, have been made. The commitment by Congress and past administrations to preserve the stock, or at the very least protect low-income, subsidy eligible tenants, have built housing subsidy expenditures into the fabric of the Federal budget.

To do nothing is to decide that the Federal Government will continue to spend subsidy dollars through the FHA Fund on an inventory of projects it will own and manage. While this decision may appeal to some, because the required subsidies do not have to be specifically appropriated, it has a significant hidden cost that may spell potential disaster for affected tenants, projects, and communities. With HUD ill-equipped to own and operate large numbers of distressed properties, the rapidly growing inventory will continue to deteriorate, blighting the surrounding communities and hampering local revitalization efforts.

The GAO, in recent testimony before the House Subcommittee on Housing and Community Development, properly framed the issues now facing us. In describing the current management and disposition process they said:

“. . . the shortfall between property revenue and property expenses will be paid by the Federal Government. This will occur whether or not the properties are sold and managed by the private sector or kept in inventory and managed by HUD. If the properties are sold, currently the shortfall is paid for with Section 8 rental subsidy which is funded by appropriations with HUD's discretionary budget authority. If the properties remain in inventory, the shortfall is funded through the FHA's General Insurance Fund. The real questions, Mr. Chairman, are (1) how the Congress wants to fund the preservation of this low-income housing, and (2) who the Congress wants to manage it. Current budget considerations result in a bias toward funding preservation through the FHA's General Insurance Fund and having HUD manage the inventory.”

The GAO is correct. The current situation has been forcing us to collectively make the wrong decision for dealing with the management and preservation issues. It is simply not sound management for the Federal Government to try to manage and own this inventory. Such an approach has not worked in the past and will not work in the future. It will ultimately increase costs and will adversely impact the affected tenants and communities.

I believe that the best way to preserve this stock as an affordable low-income resource is to return that stock to community and private sector management. If we are to spend the money, we need to spend it effectively.

Mr. Chairman, when I came to HUD, I inherited a problem that had been building for years. As I have just explained, this problem is complex and costly. It has taken a long time to get into this mess, and it will take a long time to get out. We will have to make hard decisions to solve this crisis—for that's what it is—to cut our losses, and to protect the insurance fund so that it can continue to help low- and moderate-income families get the housing they need.

There are two primary thoughts I want to leave with you and the Members of this Committee today:

First, we at HUD are taking action on every front that is statutorily permissible.

Second, we need your help to solve the problem—we need legislative relief, and we need it this year.

That concludes my statement, Mr. Chairman, and I will be happy to answer any questions you or the committee may have.

TESTIMONY OF ALAN R. CRAVITZ

Once upon a time, I can't remember how many years ago, HUD and owners reacted to the possible assignment of a defaulted loan with great concern. The few tools available in those days were used as aggressively as possible to prevent a loan assignment—a "hit on the insurance fund". Sometimes it worked, sometimes it didn't, but everyone always tried.

Things are different now. HUD employees, at least the ones we deal with at the local level, seem to think each problem project as "just another assigned loan". I must believe they have had help from the Central Office in thinking this way. The last Administration commonly referred to developers with the epithet "greedy" developers. "These guys deserved to have these loans taken back."

I remember talking to a group of HUD interns about the difficulties of maintaining rental housing during these tough times and, instead of their understanding the problems, their reaction was that "we deserved anything that happened to us" since we "ripped off the system".

Several years ago HUD issued a memorandum that was titled *Comprehensive Servicing Plan*. This plan called for a physical inspection of all multifamily properties insured by HUD, the obvious purpose of which was to identify any physical deficiencies or deferred maintenance items needing attention. No one can disagree with that objective. The local HUD personnel, however, had a different interpretation of this memo's purpose—to declare loans in "technical default" for owners failing to "maintain their property". They must have been right since form letters were sent to owners listing corrective work that HUD felt needed to be completed, requiring that the owners address these needs within thirty (30) days and threatening foreclosure if action was not taken quickly. There was no talk of any money, no one had any ideas as to where necessary funds to do any of this work would come from.

I start my testimony this way since I believe that before any ideas that I propose can be implemented HUD must be convinced, once again, that default is a dirty word. Certainly the owner is being punished, but so is HUD and so potentially are the tenants of HUD insured properties. Many things can be accomplished if the cooperative attitude that once existed between HUD and its clients can be renewed.

Unlike those old days, we now have many tools to help prevent the default and assignment of HUD insured mortgages. The primary tool is today's interest rate environment which allows long term financing of HUD insured debt at the lowest rates in twenty (20) years. Both HUD and owners should be examining projects in their portfolios to determine which loans would be eligible to take advantage of today's low interest rates.

My favorite example of how HUD manages to complicate even the simple task of reducing interest rates on currently insured mortgages is the 223(a)7 program. Congress added Section 223(a)7 to the National Housing Act years ago to allow HUD the opportunity to refinance existing HUD-insured loans at lower interest rates—a provision that helps the owners and HUD. This statutory provision takes about two or three sentences. HUD then drafted regulations for this program that added further restrictions not contained in the original Statute—such as limiting the amount of the refinanced loan to 90 percent of the project value.

I recently tried processing a loan under the (a)7 provisions refinancing from 9.75 percent to 7.75 percent per annum the interest rate on a \$1,056,000 loan. HUD initially turned down the application based on an "appraisal" of the property of \$900,000. When I pointed out to them that, notwithstanding their determination of value, any risk to the Department had already been incurred when they first insured the loan ten years ago, and reducing the interest rate would only forestall or prevent the assignment of this loan, they in turn pointed to this value criteria in the regulations. Fortunately, the Regional Housing Director agreed with my conclusion and helped in resolving this value problem. (I have been told for months, maybe even a year, that proposed regulations to eliminate this "value" criteria are about to be issued. Maybe Congress can help in this small regard.)

The story of the 223(a)7 program gets worse. What good is a HUD program without a handbook? And so now we have a 223(a)7 handbook. I have written at other times regarding my feelings about the HUD handbook procedure, but I would like to add just one comment at this time. Statutes and regulations are subject to public scrutiny prior to enactment or adoption. Handbooks are not and so HUD, at least in the past, has used this method to tighten and restrict the intended uses of HUD programs. To make matters worse, HUD regulations pursuant to the HUD Reform Act now require written waivers of handbook provisions. So, not only do Congress and the public have no input in what goes into a handbook, even modest modification requires approval from HUD Central Office. (Even though it is not the purpose

of this testimony, I ask that Congress please reconsider many provisions of the HUD Reform Act.)

Remember where we started with the simple request that we reduce the interest rate on the existing HUD-insured loan. Now we have handbook requirements that require architectural reviews, environmental reviews—a list of unnecessary items that have no connection with reducing the interest rate and preventing a loan from being assigned. And what of my project that had the problem of overcoming the “value requirement”? Well now it has a problem complying with the 223(a)7 lead based paint requirement. I guess that at a 9.75 percent interest rate it's okay to have lead paint, but at 7.75 percent it's not. And what happens when HUD takes this loan back since we were unable to refinance? An assigned loan with lead paint.

One more comment about the (a)7 program. HUD decided that co-insured loans do not qualify under the 223(a)7 program. Why? I'm told that the (a)7 program proceeded the co-insurance program and its use was therefore not contemplated with co-insured loans.

I apologize if I have belabored the point of the 223(a)7 program, but I believe it to be a valuable discussion. If I accomplish nothing else appearing before this Committee, I would consider this testimony successful if this program could be made to work. A HUD official told me that he envisioned this program being replaced by a “two-sided postcard” wherein I send in my request for an interest rate reduction and HUD returns the postcard with their approval that same day. I completely agree. Also, the implementation of this program, particularly at the local level, points out better than anything I can describe some of HUD's problems. Handbooks and regulations have replaced common sense and good judgment. I assume that most people I spoke to about my 223(a)7 loan recognized that it was a good thing to do for the Department, however, rules are rules, not to be broken, not even to be stretched. My requests were responded to with the latest HUD mantra about the IG, the Inspector General, in the background watching what every HUD employee says and does.

Another problem that the (a)7 program points out is that many of the available programs and resources to prevent loans from default and assignment are being administered by the Housing Development Division of HUD and not the Housing Management Division. Whereas the Housing Management Director has almost no say in processing the 223(a)7 application, the Development Director (who has most likely had no involvement with the property for years) has all the authority.

Other programs suffer the same fate. Not long ago I met with a Housing Development Director to discuss an “operating loss loan” for a \$20,000,000 high rise project in downtown Chicago. The owners had agreed to fund an additional \$500,000 in consideration of HUD insuring a \$1,000,000 operating loss loan. This influx of \$1,500,000 would have prevented a default for at least five years (if not forever), but the HD Director decided this was a bad deal for HUD. The loan eventually was assigned, but more about this case later.

Another example presents a case that still has time to be saved. A client came to me several years ago with a project in a medium sized Southern city with an expiring Section 23 lease with the local housing authority and an insured mortgage that would most certainly go into default once the lease had expired. We quickly put in an application for Section 8 Loan Management Set Aside funds to replace the rental subsidy provided by the Section 23 lease. At the same time we asked that HUD insure a mortgage under Section 241(a) to finance necessary repairs and upgrades to this project which had been under local housing authority operation for twenty years. The response to this application from HUD points out, once again, the problem of Development versus Management. The Management Staff in the Central Office decided that funding of the Section 8 Set Aside should not be available until the Section 241(a) loan for repairs had been approved by the Development Staff of the local office; the Development Staff of the local office, talking to their superiors at Central Office, decided that they could not underwrite and process the 241(a) loan without knowing for certain that the project would be receiving the Section 8 rental subsidy. We think that we have now (two years later) resolved this problem, hopefully, in time to prevent another default.

HUD needs to consider moving the loan programs such as 223(a)7, 241(a), 223(d) (“operating loss loans”) entirely out of the development branch and into management where they belong.

Several years ago HUD introduced a concept whereby a lender at its sole option could assign a portion of a HUD insured loan and not the entire loan to HUD. The theory behind this innovative program was that even a loan in default could service some portion of its debt and that by accepting assignment of less than the full mortgage HUD could reduce claims against the insurance fund. Once again, this simple concept produced complicated handbooks and instructions for the field office loan

servicers. Let's go back to that Chicago high rise that was denied the operating loss loan. Our next step was to convince the lender not to assign the \$20,000,000 mortgage, but to submit to HUD a "partial payment of claim" for \$5,000,000. After seven (7) months of "processing" by HUD the cooperative lender decided that they could no longer wait for HUD to process this partial claim and assigned the entire \$20,000,000 loan to HUD.

It seems that certain changes could be made to this program that would make it the useful tool it was intended to be:

1. There should be a mandatory requirement that lenders submit "partial payments of claim" prior to assigning the entire loan to HUD for insurance benefits;

2. Lenders should be required to reduce the interest rate on the portion of the loan they retain to the lowest level attainable in the marketplace at that time;

3. Lenders who are refunding or are unable to accomplish items (1) and (2) should be required to sell (at par) the loan to a lender agreeing to these two provisions before being allowed to assign the project loan. (This should also be the case for projects that utilize the 223(a)7 program); and

4. HUD should accept partial payments of claim without the need for any complicated calculations. HUD actually went so far as to develop computer software to determine the maximum amount of any partial claim. Also, formulas have been developed tying the maximum "partial payment of claim" to the amount of equity contributed by the owner. It seems as if someone could easily figure out the maximum debt the project could support at the lowest possible interest rate and that the balance would be assigned to HUD and held as a "soft" second mortgage.

In the 1980s, many projects were financed using tax exempt debt. Many of these projects now have an opportunity to significantly reduce interest rates on their loans to rates currently as low as 6 percent per annum. Another program, another handbook, another attempt to delegate approval to the field office where our loan servicer has now been asked to be an investment banker. They have my sympathy. After 20 years of financing multifamily housing, many times involving tax exempt financing, the world of the investment banker remains a mystery to me. Just as in the 223(a)7 program, bond refunders only help projects from defaulting by in every case reducing the debt service payment on the outstanding loan. This process should be quick and simple and not take eight months to process as was the case of our last bond refunder.

Obviously, there are tools to try to prevent or to at least minimize the exposure to HUD of defaulted mortgages. Now for those projects that have already been assigned to HUD. It is imperative that HUD get out of the lending/loan servicing business by selling off as soon as possible as many of the loans as it can from its portfolio. Aside from the time involved in servicing mortgages, it goes without saying that if HUD is not the lender, then they won't be the owner, and so the number of properties that are foreclosed by HUD would be significantly reduced. We recently had a case where an attorney friend called and asked if we could help stop the assignment of a loan on a project owned by one of his clients. We first asked the lender if they would agree to reduce the interest rate on this loan rather than assign the loan to HUD. After they refused this option, we offered to buy the loan from them at par, paying off any arrearages on the loan as well. We would have then reduced the interest rate rather than see the loan assigned. The lender once again refused—for reasons we will discuss later—and the loan was assigned to HUD and the claim paid. We then called the HUD Central Office and asked that HUD reinsure the loan and assign the newly insured loan to us for which we agreed to reimburse HUD for all costs, arrearages, etc. The HUD official, who I have known for a long time and respect greatly, clearly embarrassed, turned down my request and went on to explain that current HUD policy only allowed HUD to reassign this loan to the assigning lender, in this case, the same lender we found so uncooperative in the first place. This policy should and must be changed. (I understand that even GNMA is unwilling to accept reassignment of assigned loans—even for only the brief time it takes to reassign the loan to a cooperating lender.)

You may be interested as to one of the reasons the lender was so uncooperative, after all what difference should it make if the claim is paid by HUD or if we purchase the loan from them for the same amount. The reason was that the lender planned on having the claim settled with HUD debentures, in this case bearing an interest rate significantly higher than the rate on the mortgage note or current interest rates. (The rate on the debentures which would be applicable at the time of an assignment is established at the time the loan commitment is initially issued—not at the time of assignment.) In most cases HUD should eliminate the payment of claims in debentures or issue the debentures at interest rates tied to current market rates. This would stop this costly game.

As stated earlier, HUD needs to sell off its loan portfolio. It has done this from time to time, most recently selling pools of loans assigned to HUD under the 221(g)4 option. For some reason, I have been told many different stories, HUD has stopped selling its insured loan portfolio. I have not had a chance to think about a precise pricing structure, but this program would be the inverse of the "partial payment of claim" program. Loans or portions of loans, based on the maximum amount of debt that is supportable at current market interest rates, would be sold in the marketplace. HUD would retain, if necessary, that portion of the loan that could not be serviced based on an analysis of the underwriting, as well as any arrearages that had accumulated during the time HUD had been the lender. This "soft" second mortgage held by HUD should be treated as a participating loan and would be serviced by a share, say 50 percent, of project cash flow. This second mortgage would be due upon sale or refinancing of the property. (I guess I can see some loop holes in this approach, but we just have to assume that most people are even-handed in their dealings with HUD and that by complicating the program to close off any loop holes we find ourselves back at the stage where we started—unworkable rules and handbooks.

This approach, a participating second mortgage, should also replace the current HUD workout arrangements. HUD policy now requires that in most instances owners provide HUD with a workout plan that would bring the loan current and pay off any arrearages within three years of assignment. This is easy to accomplish on the computer, but impossible in the real world. Most projects that are in the tenuous financial position that required the loan to be assigned are not about to be economically healthy in three years, probably not even in nine years as contemplated in a proposed HUD handbook. I understand that half of the defaulted projects currently under workout with HUD are in default under the workout agreement. I am surprised that the percentage is not greater. HUD needs to stop treating the concept of negotiating a workout agreement with the owner as the answer to the project's problem or as a legitimate goal.

Anyway, HUD's definition of workout would be unrecognizable in the conventional real estate business. After a loan is assigned to HUD, the owner receives a letter asking him to schedule a meeting to discuss a workout agreement. The first thing the owner proposes is that HUD reduce the interest rate on the loan since at least at this time there is a good likelihood that the current interest rate (and particularly the cost of funds to HUD) is significantly less than the rate on the mortgage note. HUD (for some reason) is unable to negotiate a reduction in the interest rate. The next request is that HUD agree to forgive a portion of the debt. HUD cannot agree to that either. At that point, not much is left to be said at the meeting.

Many years ago now, a developer had a loan assigned bearing a 9.75 percent per annum interest rate. Each month the owner remits all the project's cash flow to HUD, an amount insufficient to cover the monthly mortgage payment, so that the arrearages continue to grow and grow and grow. HUD can't sell the loan with mortgage insurance, HUD is unable to reduce the interest rate being charged and so it goes. This owner has tried his best, not even taking a management fee for years, with almost no hope that he will ever see any return out of this project.

We all know of cases where owners of properties have been negligent in their responsibilities and in those cases HUD should feel no obligation other than to move quickly to foreclose and sell the real estate. We all make some mistakes. But in most cases HUD should take advantage of the current interest rate climate and the many tools at its disposal to work with the current owners of the properties to solve their mutual problems.

I am not sure I've said anything profound—just accurate.

TESTIMONY OF JAMES R. GROW NATIONAL HOUSING LAW PROJECT

The following statement is submitted by the National Housing Law Project to the Senate Housing Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs at the request of the Subcommittee Chairman for its hearing on "Issues in Multifamily Housing" on June 22, 1993.

Since 1968, the National Housing Law Project has been a resource center on housing matters for attorneys and other advocates representing people at or near the poverty level all over the country. From these 25 years of experience, we have gained an extensive body of knowledge regarding the housing needs of poor people, as well as the actual operations of the federal housing programs.

I. SUMMARY OF THE TESTIMONY

Preservation of the HUD multifamily inventory facing foreclosure or other disposition by the agency is one of the highest housing priorities for very low-income families. It must be viewed not just in fiscal terms, but also in light of its consequences for the tenants who call this housing their home and for the neighborhoods it affects. Congress has repeatedly emphasized the need to preserve this housing, but HUD has been a reluctant agent of this policy the past 12 years. Because of this hostility, current law has not been given a chance to work. HUD's failure to obtain sufficient funding for the program has produced a buildup in the inventory, but this problem should be handled by increased funding and the development of a more comprehensive policy, including both improved mortgage servicing and disposition planning, not by reducing the commitment to preservation.

II. FRAMING THE PRESERVATION ISSUE

We focus our testimony on two related major issues: HUD's multifamily mortgage servicing and oversight policies and practices, and HUD's foreclosure and property disposition policies. The Clinton Transition Team, the HUD Inspector General, and the General Accounting Office have all properly identified the property disposition program as a major management problem with enormous fiscal implications for HUD. No one would dispute that this problem, of which mortgage servicing represents the preventative side of the coin, is extremely important. Secretary Cisneros has stated that multifamily disposition will comprise one of his top legislative priorities, and no doubt we will hear more about HUD's position at today's hearing.

We appreciate the fact that Congress is now beginning to focus again on this critical part of the housing preservation issue, after years of administrative neglect and weak oversight. We strongly believe, however, that resolution of these problems will require a multifaceted approach, consisting of administrative and staffing reforms, policy revisions, regulatory amendments, appropriations, and perhaps legislative revisions. We caution that HUD and Congress should move deliberately, with full consultation with all concerned parties, especially the affected tenants and communities, to develop a rational approach. This problem was not created overnight, and cannot be solved with any kind of quick fix.

We look forward to receiving and analyzing HUD's proposals in this area, which have been rumored for several months. We also welcome the administration's budget request for Fiscal Year 1994, which seeks increased funding for the property disposition program, from its current negligible FY '93 level of 953 units annually to 2,500 units annually. We also support the proposed modest increase through the reprogramming of \$80 million via the FY '93 Supplemental Appropriations bill, which will provide 15-year subsidies for another 820 units. While obtaining these funds is a step in the right direction, it is certainly inadequate to deal with the magnitude of the problem we face.

We caution HUD and Congress not to view this issue solely in financial terms. That myopic approach has already been repeatedly rejected over the last 20 years by the courts¹ and by Congress.² This is not to say that preservation is not costly in financial terms. We must recognize that providing housing for a wide range of very low-income families is expensive and look for cost-effective ways to accomplish that mission. Preservation of the stock that we now have will usually be the most cost-effective alternative in the long-run, when coupled with the other essential ingredients of a successful housing program. While preservation may be expensive, the costs of failing to develop an effective preservation policy are even more expensive, especially when one considers the costs of providing resources for the eventual increase in the homeless population resulting from the loss of affordable housing and the human and social impact on lives and neighborhoods.

¹ See e.g., *Cole v. Lynn*, 389 F. Supp. 99 (D.D.C. 1975), *aff'd on other grounds*, 571 F.2d 590 (D.C. Cir. 1977), *rev'd on other grounds*, 441 U.S. 39 (1979) (maximizing financial return to HUD is not an acceptable housing policy).

² See the preservation statute, § 203 of the Housing and Community Development Amendments of 1978, as amended by § 181 of the Housing and Community Development Amendments of 1987 and subsequently, all codified at 12 U.S.C.A. § 1701z-11 (West Supp. 1992). See also *Hearings Before a Subcommittee of the House Committee on Government Operations*, 98th Cong., 1st Sess. (May 24-25, 1983, and July 1983); "HUD Is Not Adequately Preserving Subsidized Multifamily Housing," Eleventh Report by the House Committee on Government Operations, H. REP. NO. 98-477, 98th Cong., 1st Sess. (Nov. 3, 1983); and *Hearings on HUD's Multifamily Property Disposition Program Before a Subcommittee of the House Committee on Government Operations*, 99th Cong., 1st Sess. (Feb. 20, 1985). In 1986, HUD's attempt to revise the 1978 statute via Senate legislation was also rejected.

But preservation is not just a financial problem. It is an important method for ensuring we are doing everything possible to meet growing housing needs. During the 1980s, the need for decent and affordable housing for very low-income families steadily increased. More people are poor, and they face escalating real rent burdens as a consequence of a diminishing supply of private housing affordable to them. At the same time, during the last decade, we have witnessed a near halt in federal assistance for the addition of new low-income units to the supply to meet this growing need.

The Clinton Administration's budget for Fiscal Year 1994, while perhaps arresting the decline in additions to the supply, provides funding for very few new low-income units. Preservation of what we have is therefore vital to meet growing needs, due to the cost and difficulty of replacing units that are lost from the low-income housing stock. In most cases, the admittedly substantial cost of preservation is far less than the cost of replacing units, especially for units that are in basically sound physical condition. Congressional action throughout the 1980s strengthening preservation mandates throughout the federal programs recognized this basic proposition, despite repeated attempts by HUD to withdraw from this commitment.

We must also recognize that we are not dealing simply with so many dollars or so many units. We are dealing with people's homes and the needs of tenants who are served and could be served by this housing. This reality requires that tenants be involved in developing solutions for these problems at every step of the process, both during ordinary mortgage servicing and project oversight activities, and especially during major decisions presenting a threat to their security, such as foreclosure or disposition.

Another critical facet to be recognized is the impact of these troubled developments and HUD's policies and practices on surrounding neighborhoods and communities. Preservation can be an important part of a strategy to revitalize or rebuild a community. The actions or neglect of HUD and the owner made the project what it now is. It would be irresponsible to follow a policy of neglect with a practice of abandonment. HUD has a legal and moral responsibility to these complexes, these tenants and their neighborhoods, to resolve them in a way that fulfills the national housing goal of "a decent home and suitable living environment for every American family".

One also cannot consider preservation policy for these developments without analyzing the fair housing implications. In many cases, the tenants of these units are predominantly minority. Often the developments contain larger units that are desperately needed by families with children. Given the barriers to utilizing the private market, it may often be impossible to provide housing opportunities for these families through any method besides a comprehensive preservation strategy. Considering the characteristics of others in the community in need of decent and affordable housing only serves to reinforce the need for preservation. It would be shameful and discriminatory if Congress or HUD were to fail to preserve these units, while simultaneously preserving those with higher economic values and fewer poor and minority tenants under the prepayment preservation program.

All of these features must inform the development of a comprehensive preservation policy. In addition, after the experience of the last 12 years, it is essential to devise a policy that can survive a change in administrations. Any legislative reform that permits administrative discretion to make preservation decisions on a case-by-case basis will only recreate the problems that existed under the Reagan Administration which were so strongly countermanded by Congress.

III. BRIEF HISTORY OF THE PROPERTY DISPOSITION PROBLEM AND POLICY

Most of the HUD units at issue here were constructed under various HUD subsidy and insurance programs during the late 1960's and during the 1970's. For one reason or another, or for a variety of reasons, some of these buildings encountered financial or physical difficulties. Under the insurance contracts, private lenders assigned the loans to HUD in exchange for payment of the mortgage principal. HUD typically would attempt to enter into a work-out plan with the owner to satisfy the delinquencies and, if those efforts failed, HUD would eventually move to foreclose on its loan. At foreclosure, a complex would be sold to the high bidder, which in many cases was HUD, which bid in the amount of its debt. In those latter cases, HUD would become the owner of the project and attempt to re-sell it through the property disposition process.

When this cycle began to surface in the mid-1970s, HUD would either sell the project to the highest bidder or demolish the property, seeking whichever alternative would yield the highest return to the Mortgage Insurance Fund, which had been debited to pay off the original loan. After this practice was repeatedly chal-

lenged in the courts, Congress took action in 1978 to establish a statutory framework for the property disposition program, by outlining federal preservation goals far broader than maximizing financial return—goals which appropriately recognized the need to assess the impacts on tenants and the community in developing a disposition plan.

HUD promulgated regulations to implement this statute in 1979, and those regulations remain in effect today, despite repeated agency attempts to revise them. See 24 C.F.R. part 290 (1992). These regulations adequately established a disposition program ordinarily emphasizing preservation, while allowing administrative discretion for other outcomes such as sale without subsidy or demolition in appropriate cases.

During the early 1980s, HUD began taking actions contrary to the statute and the rules, such as proposing to effectively repeal the regulations, adopting policies inconsistent with the statute, rigging bids at foreclosure to avoid taking title and preservation rules, and making repeated decisions waiving the regulations. Congress was compelled to re-enter the picture.³ Because HUD would not retreat from its desire to repeal the preservation aspects of the rules, legislation was introduced in 1984 to effectively codify the rules in the statute. See H.R. 5254, 98th Cong., 2d Sess. (Mar. 27, 1984). This legislation sought to address the numerous points in the life of a subsidized multifamily complex when the units could be lost to continued low-income use. The basic thrust of this bill with respect to foreclosure and property disposition was to codify the existing regulations requiring sale of formerly subsidized projects with subsidies, while for the first time providing authorization for subsidies to prevent the loss of units at the point of foreclosure.

The essential features of this bill were eventually enacted by Congress as part of the Housing and Community Development Act of 1987. Pub. L. No. 100-242, §§ 181-186 (Feb. 5, 1988). This amendment generally requires the preservation of formerly subsidized developments,⁴ both at foreclosure and when sold from the HUD inventory. The statute also clarifies that cost is a consideration only in selecting among alternatives that further the non-financial statutory preservation objectives. To preserve these units, HUD must generally provide project-based Section 8 assistance, if appropriated funds are available, reduce the selling price, or provide purchase money financing sufficient to reduce rents to 30 percent of tenant income. As amended in 1990, HUD must "preserve" only those units in formerly unsubsidized⁵ projects that are occupied by low- or moderate-income tenants (*i.e.*, not vacant units), but can use tenant-based certificates (which are hardly cheaper than project-based subsidies) in appropriate markets.

HUD may avoid these preservation obligations only where a project cannot be properly rehabilitated within Section 8 Substantial Rehabilitation subsidy levels, or if decent and affordable low-income housing is not needed.⁶

To arrest the cycle of deterioration, the statute also requires HUD to maintain in habitable condition and at full occupancy the developments that it owns or controls, except in limited circumstances. The law also gives state and local governments a right of first refusal to purchase projects being sold at foreclosure or from the HUD inventory.⁷ In late 1992, HUD finally proposed regulations to implement these 1987 preservation requirements.⁸

During the early 1980s, Congress regularly appropriated sufficient funding to operate the property disposition program, typically ranging between 5,000 and 15,000 units of Section 8 subsidy annually. However, HUD often did not use all of the fund-

³ For detailed background on the development of Congressional and HUD property disposition policy, see Statement of the National Housing Law Project in *Hearings Before a Subcommittee of the Committee on Government Operations*, 98th Cong., 1st Sess. (May 24-25, 1983), at pp. 53 *et seq.*

⁴ "Formerly subsidized" projects are generally those which, prior to HUD ownership, received subsidies to reduce their mortgage interest rate, such as Section 221(d)(3) BMIR or Section 236 subsidies, or which received deep project-based subsidies such as Section 8, Rent Supplement or Section 236 RAP Payments. Under the 1987 preservation statute, as amended in late 1988, a "subsidized project" is defined as any project that receives assistance in the form of subsidy payments or direct loans (prior to a mortgage assignment) under the Section 221(d)(3) BMIR, Section 236, Rent Supplement, Section 202 or Section 312 programs, or assistance payments under the Section 23 or Section 8 programs (except Section 8 Existing Housing), so long as the assistance payments are made for more than 50 percent of the project's units. 12 U.S.C.A. § 1701z-11(i) (2) and (3) (West 1989).

⁵ These are those multifamily projects that had HUD-insured mortgages but did not receive the assistance that qualifies them as "formerly subsidized" projects.

⁶ H.R. REP. NO. 122, 100th Cong., 1st Sess. 39 (1987).

⁷ This provision was substantially rewritten in 1988. Pub. L. No. 100-628, § 1010(c), 102 Stat. 3266 (1988), codified at 12 U.S.C.A. § 1701z-11(e) (West 1989).

⁸ 57 Fed. Reg. 34,834 (Aug. 6, 1992).

ing appropriated during the early 1980s. Appropriations began to decline in the mid-1980s, generally to the 3,000 to 5,000 unit annual level, reaching rock bottom in FYs '92 and '93 at 953 units.

IV. SCOPE AND CAUSES OF THE PROBLEM

A. Scope of the Problem

The GAO has recently testified on the disposition problem, providing some figures about the size of the inventory in question.⁹ The GAO indicates that the inventory of HUD-owned multifamily units has grown dramatically over the last three years, from 10,000 units in 1990 to 27,000 units in 1992. In addition, according to the GAO, HUD has "initiated foreclosure" on another 42,000 units. According to the GAO, *less than half*, only 31,200 units, out of this total of 69,000 units that are either under foreclosure or now owned by HUD, must legally be preserved for lower-income use under current law. (This 31,200 units is a HUD-Headquarters estimate; HUD field offices estimate that only 26,000 units, or *not even 40 percent*, require preservation.)

From the GAO's testimony, it is unclear how many of these 31,200 units are HUD-owned and how many are under foreclosure. Because of the HUD/GAO characterization that HUD has "initiated foreclosure" on 42,000 units, it is unclear exactly when the foreclosure sale itself would be held, which is the point at which subsidy would have to be attached and budget authority utilized. Also bear in mind that just because the foreclosure sale is held, it is not necessarily true that budget authority is utilized at that point, since HUD may be the high bidder at the foreclosure sale and take the project into its inventory. At that point the HUD-owned disposition planning process is then commenced, and the project may not be sold for a year or longer.

Thus, the GAO's figures, insofar as they rely on the "under foreclosure" characterization to create an appearance of an insurmountable fiscal crisis, must be reviewed with extreme caution.¹⁰ It is probably fair to conclude that we have a current subsidy need for whatever portion of the HUD field estimate of 26,000 units requiring preservation are actually owned by HUD, as well as those which will face a foreclosure sale in the coming fiscal year (recognizing that some of the latter category may be acquired by HUD at foreclosure and thus not require Section 8 subsidy).

These distinctions are very important in assessing the magnitude of the problem facing us, because the policy response these days is often primarily influenced by budgetary concerns. The immediate problem may well be less than first indicated by the GAO testimony and HUD estimates.

B. Causes of the Problem

The search for causes should begin with a look at a recent history of the appropriations level for this program. Over the same three-year period (from 1990 to 1992) that GAO found the HUD-owned inventory growing from 10,000 units to 27,000 units, appropriations for the program totaled less than 7,000 units. Bear in mind that these subsidies had to cover not just sales from HUD's own inventory, but also the preservation of those units purchased by an entity other than HUD at foreclosure.¹¹ The point is this: during this period, had funding been provided for more rational levels of property disposition (similar to the number of units requested, never exceeding 10,000 units annually, but with either 15-year contract authority or FHA mortgage insurance), similar to modest levels matching those of the first few years of the Reagan Administration (usually around 10,000 units annually), we would not be facing this "crisis" with respect to disposition of the current inventory. In fact, even a meager appropriation of 5,000 units annually would probably have been sufficient to maintain the HUD-owned inventory at its 1990 level of 10,000 units.¹²

⁹United States General Accounting Office, *Testimony Before the Subcommittee on Housing and Community Development, Committee on Banking, Finance and Urban Affairs, House of Representatives*, "Multifamily Housing: Impediments to Disposition of Properties Owned by the Department of Housing and Urban Development," No. GAO/T-RCED-93-37 (for release on May 12, 1993).

¹⁰It is also possible that foreclosure will never be completed on some of these projects, as last-minute workouts also occur as the owner and HUD continue to negotiate.

¹¹During this same period, the GAO report indicates that the Bush Administration's budget requests exceeded 21,000 subsidy units, a far more realistic figure. However, those requests for only a five-year contract term with no insurance, which would not permit financing of needed repairs, were also inadequate.

¹²This is because of the 17,000 units added to the HUD-owned inventory between 1990 and 1992, an unknown but significant number of them are in formerly unsubsidized projects that

Continued

Thus, the steady dwindling of appropriations for the program from FY 1985 onward to the current meager level is chiefly responsible for the size of the current inventory. According to the recent GAO testimony, HUD has not requested sufficient funding during the past few years to operate the program properly.¹³ Since HUD has not supported the authorized preservation program for many years, it is also no surprise that the appropriations committees failed to provide even modest appropriations, given recent fiscal pressures that have annually forced reductions in new incremental units.

As to what is responsible for the large number of units "under foreclosure," and just what this term means in terms of the certainty of subsidy need and its time frame, remains unclear. But certainly the flat or depressed real estate markets in many areas of the country over the last three years, caused in large part by overbuilding in some areas (due to the ill-advised tax incentives of 1981) and general economic conditions, together with the 1986 reduction in tax incentives, have been significant contributing factors. Inadequate HUD mortgage-servicing staffing levels, which force HUD staff to be responsible for an unrealistic number of developments, have only exacerbated these problems. The extent of these problems has also been compounded by years of insufficient budget requests and actual appropriations for foreclosure and property disposition, since many HUD offices are unlikely to aggressively pursue owners in violation if to do so would only add to an already clogged pipeline. Thus, this problem cannot be solved overnight.

We must also resist the temptation to view this problem as insurmountable since the likely implication of such a characterization may be to substantially relax the existing preservation requirements. It is not insurmountable. In 1979, HUD owned 385 projects with approximately 40,000 units.¹⁴ It somehow managed to reduce its inventory to manageable levels under preservation requirements (the 1979 regulations still in effect) substantially similar to the current statutory framework.

Over the last decade it became fashionable to accept the characterization of HUD as inept or obstructionist, incapable of solving problems. Though perhaps true in certain times and places, neither Congress nor HUD should ever develop policy on this fatalistic premise. An activist HUD committed to preservation can solve these problems, given the leadership, the staffing, a comprehensive policy, and adequate funding. This is not a time for panic or a fire sale. It is the time to make up for the extreme funding shortfalls of the last six or eight fiscal years, to make this issue a departmental priority, and to provide the staff and the training to do the job right.

Before making any legislative changes in this area, Congress must clearly define the objectives and goals to govern its policy. We believe that the statutory goals enunciated by Congress in the 1978 preservation statute, reaffirmed throughout the 1980s and strengthened in the 1987 law, properly state the correct policy objectives. As indicated by the legislative history, preservation is the "paramount" objective of HUD's foreclosure and property disposition program, although the other non-financial objectives of minimizing displacement and demolition, revitalizing neighborhoods, and so forth are vitally important.¹⁵ Fiscal concerns are certainly relevant, but only for choosing the most reasonable alternative that furthers preservation objectives to the greatest extent possible.¹⁶

We believe that the participation of the residents of every troubled development in the ongoing operations of the development, as well as in determining its future path, is also vital. Beyond improving the success of the development in meeting the needs of the residents, tenant involvement will provide better housing at less cost by forcing accountability from ownership and management that HUD has in many cases been unable to achieve. I know that HUD has received important and thoughtful recommendations from the National Alliance of HUD Tenants in this area. The preservation program should also include funding for tenant organizing and the ongoing activities of tenant organizations, as well as funding for tenant services. These changes would be extremely cost-effective.

do not require preservation under current law because they are either vacant or not occupied by low-income people.

¹³ While the number of units HUD requested over the past three years appeared adequate, it only sought five-year contract authority, which will generally not allow rehabilitation financing without HUD insurance for the loan.

¹⁴ See H. REP. NO. 477, 98th Cong., 1st Sess. (Nov. 3, 1983), at 8.

¹⁵ H. REP. NO. 122, 100th Cong., 1st Sess. (June 2, 1987), at 37.

¹⁶ *Id.* at 38.

V. SUGGESTED MODIFICATIONS

A. Request and Obtain Adequate Subsidy Funding to Dispose of the Backlog and Operate the Program

It is vital that HUD seek and Congress request adequate funding to preserve these units. People need them to live in. Neighborhoods need them to be fixed up. HUD cannot continue to neglect them, and cannot abandon them by selling them "as-is" to perpetuate a slum. Over a period of several years, or as fast as staffing resources permit, HUD should request increased funding for Section 8 property disposition to reduce the inventory to more normal levels. This may require, for example, a couple of years' funding at the 15,000-unit level in order to alleviate the backlog.

It should be noted that the \$6,500 per unit annual cost for property disposition for FY 1993 (about \$550 per unit per month) probably reflects operating expenses of around \$300 per unit per month, an acquisition price approximating HUD's cost from the insurance fund, together with debt for some moderate rehabilitation. If the unit itself were not preserved, and the tenant were given a Section 8 certificate, even assuming that the tenant would be able to find adequate housing in the market with the certificate¹⁷ (which a significant number cannot), the savings would be nonexistent or minimal.¹⁸ To obtain the guarantee of a unit of housing that is rehabilitated and actually available (so long as other essential criteria are also satisfied), not to mention the positive impact upon neighborhoods and communities of actually ensuring rehabilitation of the housing, any extra expense is well worth it. Preservation may be especially cost-effective in markets where tenant-based Section 8 FMRs are very expensive.

B. Evaluate Potential Methods of Reducing Budget Authority Requirements

Reduce the Section 8 Contract Term, But Provide FHA Insurance. Throughout the last decade, HUD has tried to convince Congress to reduce the term of the Section 8 contract from 15 to five years. This has been done with virtually all other Section 8 appropriations, from tenant-based certificates and vouchers to even project-based subsidies under the prepayment program. However, in the past, OMB has refused to allow HUD to provide mortgage insurance to accompany the five-year subsidy commitment. Without the insurance commitment, the five-year Section 8 contract alone is usually insufficient to obtain private mortgage financing for acquisition and rehabilitation, especially on a troubled development. Shifting to five-year budget authority could work, but only if mortgage insurance were provided, similar to the solution crafted for the prepayment program. This would permit the funding of three times as many units from this same amount of budget authority, even though annual outlays would be identical.

However, if Congress and HUD choose this route, they must ensure adequate underwriting criteria to avoid replication of the default/foreclosure cycle. Other HUD mortgage servicing policies and practices would also have to be reformed, and HUD's oversight of the complex would have to increase significantly. Tenants should play a vital role. Otherwise, the eventual costs from another cycle of foreclosure would be enormous.

Fund Capital Costs Directly, Using Section 8 Only for Operating Costs. There may be other ways to avoid using discretionary budget authority and Section 8 to subsidize preservation costs, but these methods would still require eventual appropriations to capitalize the mortgage insurance fund, which would assume these costs instead of utilizing Section 8. Specifically, HUD could write down sale prices of HUD-owned properties to one dollar, thus reducing the need for Section 8 to subsidize acquisition debt. Similarly, HUD could perform the rehabilitation itself and pay the costs from the mortgage insurance fund, thus eliminating the need for Section 8 to subsidize rehabilitation debt. Again, this does not eliminate the cost; it simply provides another way to finance it that does not use Section 8 budget authority. It may be cheaper in the long run to take care of these capital expenses through these methods because Treasury borrowing rates are substituted for private market interest rates, but HUD's record in performing repairs and the logistics of coordinating the nature and quality of repairs with the desires of the tenants and the new owner could prove very difficult.

¹⁷ The GAO testified that only 11 percent of the 69,000 units that must be preserved would qualify for "preservation" through providing tenant-based certificates, which demonstrates that markets generally cannot meet the statutory test of providing adequate affordable housing for using the certificates.

¹⁸ The annual subsidy cost of a Section 8 property disposition unit is currently \$6,500 per unit per year. See GAO testimony *supra*. HUD's FY '94 budget figures indicate an annual per unit cost of tenant-based Section 8 certificates of between \$5,700 and \$6,600, depending on the year.

In some developments, if HUD takes care of the capital side by writing down sales prices or providing rehabilitation grants or deferred loans, some tenants may be able to continue to pay rents similar to the pre-foreclosure rent levels, and these burdens may be affordable. If so, once the rehabilitation program were created, this could be accomplished within the existing statutory authority. In that case, some units could be preserved for current and future tenants at similar income levels without Section 8 subsidy. (One major drawback of this approach is that the unit will only be affordable to a similarly higher-income tenant upon turnover.) However, given the location, condition, and occupancy profile of most of these buildings, this may not be a widespread solution. To the extent that these capital costs were handled separately, Section 8 contract rents for those units still requiring a subsidy to make operating costs affordable would be significantly reduced, as in the new Section 202 program created by the 1990 Act.

C. Improve Mortgage Servicing and Make Tenants True Partners to Minimize Inventory Growth

In 1991, HUD adopted a new administrative policy known as the Comprehensive Mortgage Servicing Policy (HUD Notice 91-22, March 11, 1991). We believe this policy has since expired, and cannot determine its current use by HUD field staff.

This policy stated the appropriate goal, to ensure adequate housing and services to tenants, set sound objectives and established many positive policies to improve physical conditions and management in HUD developments. The concept of requiring field offices to set priorities for inspection of projects, perform inspections, document the results, require corrective action by owners within specific time frames, monitor corrective actions, and take steps for noncompliance are all logical elements of a good policy (but not sufficient, *see infra*). Especially helpful are the mandates to inspect and develop cost estimates for taking corrective action, the requirement for an owner to provide a written corrective plan per the MIO format with a budget identifying amounts and sources of funds, and the requirement that the field office have or develop a monitoring system and take corrective action for noncompliance, including seeking MIP status and foreclosure.

But this policy also displayed HUD's blind spot for tenant participation. For all the rhetoric about residents, the policy omitted a formal procedure for residents to register their complaints and have them resolved. While the policy established field office authority to review the owner's performance in resolving tenants' concerns, there is no mechanism to ensure that the field office ever hears of the residents' complaints. Nor was there any integration of resident participation into the inspection, planning, monitoring or enforcement processes detailed in the Notice, either regarding physical conditions or management. These are critical shortcomings. Resources for organizing, ongoing support, and tenant services, and protection from harassment or reprisal, will also be critical to make residents true partners.

Another weakness in the policy regarding troubled project assessment was the process of applying the criteria and setting priorities for which projects to inspect. Further, after HUD was to perform the first wave of inspections, HUD planned to delegate the inspection responsibility to the mortgagees, which gives no guarantee of adequacy. Nor did the policy require physical inspections (required prior to any additional HUD funding) prior to project-wide rent increases, which tends to emphasize the needs of the government over those of the tenants.

Allowing field offices to determine which deficiencies were "serious" (key because it determines the scope of future monitoring and remedial action) or whether and when to recommend a declaration of default without specific criteria or tenant participation was yet another problem. Other major administrative steps on HUD's part lacked mandatory deadlines, which in the past has always produced poor results. The policy contained no mandatory duty for HUD to take judicial action to obtain possession from recalcitrant owners, or to repair the complex upon MIP status. Finally, the whole policy depended upon direction from the top, as well as adequate resources and training to field offices to perform the inspections and do all of the follow-up work, including required planning, monitoring, and enforcement.

This policy, properly modified, could provide a sound foundation for the reforms needed. It will not alone address the problems of the already troubled inventory.

D. The Foreclosure and Disposition Planning Processes Should Include Full Tenant and Community Participation

Currently, HUD usually involves tenants, community groups, and local governments in the preservation planning process only where formally required, and the process does not permit enough time or resources for these parts of the solution to play a constructive role. Face-to-face meetings would be far more productive than simple notice-and-comment rights, and these should begin no later than when a

project's mortgage is assigned to HUD. Resources for technical assistance for tenants should be made available, just as in the prepayment program.

E. The Foreclosure and Disposition Processes Should Always Focus on Obtaining Competent and Responsive Ownership, Management and Rehabilitation

Current law does little to ensure that the plan pursued by HUD is the best for the development, the tenants and the community, especially when the project is sold at foreclosure with Section 8. This is a big mistake, since failing to ensure rigorous purchaser selection and sound rehabilitation will often produce significant problems downstream. Negotiated sales may well be the only practical solution to this problem. The policy should include a preference for tenant and community-based ownership, as in the prepayment program, so long as reasonable criteria can be satisfied and long-term preservation assured. State housing finance agencies may be an important player here, and could assume some of the financing risk and processing and servicing burdens.

TESTIMONY OF JAMES L. LOGUE III

EXECUTIVE DIRECTOR OF THE MICHIGAN STATE HOUSING DEVELOPMENT AUTHORITY

Mr. Chairman, Senator Bond, and Members of the Subcommittee, I am very pleased to testify this morning on issues in multifamily housing.

I am James L. Logue III, Executive Director of the Michigan State Housing Development Authority (MSHDA) and former Deputy Assistant Secretary for Multifamily Housing Programs at HUD. I am testifying this morning on behalf of the National Council of State Housing Agencies (NCSHA).

NCSHA is a national, nonprofit organization created in 1970 to assist its members in advancing the interests of lower income people through the financing, development, and preservation of affordable housing. NCSHA is the only representative of state or local government exclusively devoted to the full range of affordable housing issues.

NCSHA's members are the state agencies which finance affordable housing in all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands. State Housing Finance Agencies (HFAs) have issued \$74 billion in Mortgage Revenue Bonds (MRB) to finance more than 1.5 million lower income families' home purchases and \$26 billion in bonds to finance over 500,000 rental apartments for such households.

NCSHA's members also allocate the Low Income Housing Tax Credit (Tax Credit), which, since 1987, has financed over 500,000 apartments for low income families. In 34 states, NCSHA's members administer over \$600 million in HOME funds to support a wide range of affordable housing programs for low income families. In additional states, HFAs contribute to HOME administration through project evaluation and underwriting. Collectively, HFAs operate more than 600 affordable housing programs, which range from homeownership to homeless initiatives.

HFAs are substantial players in the housing finance market with combined assets of over \$78 billion. Although they are state-chartered, HFAs are required to be self-sufficient and receive no operating funds from their state governments.

MSHDA has been offering mortgage financing for multifamily developments for more than 22 years. MSHDA has utilized virtually every form of housing assistance offered by Congress and HUD, including Section 236 interest reduction funding, Section 8 subsidies, rent supplements, housing development grants, Section 8 moderate rehabilitation funds, and since 1986, the Tax Credit. By the end of 1992, MSHDA had financed more than 45,068 units in 315 separate developments. Of these, only 1,230 units in eight projects are FHA-insured; two projects totalling 195 units were coinsured by HUD. Effectively, MSHDA has self-insured 98 percent of its portfolio.

I want to make three points in my testimony today.

1. There is a serious need for affordable multifamily housing in this country, but over the past several years HUD has made only modest gains in meeting this need because of limited resources, unsuccessful management, and insufficient data systems.

2. HUD faces imposing challenges in producing new affordable housing, and in preserving the existing stock of assisted multifamily housing and disposing of its own inventory for long-term affordable use.

3. HFAs are strong financial partners and capable housing providers that can help HUD meet our country's affordable multifamily housing needs.

THE NEED FOR AFFORDABLE MULTIFAMILY HOUSING IS OVERWHELMING

Our country is experiencing serious and persistent multifamily housing needs. According to *The State of the Nation's Housing, 1993*, published by the Joint Center

for Housing Studies of Harvard University, from 1985 to 1989 the affordable housing stock suffered a net loss of 197,000 rental units each year. From 1985 to 1992, median renter household income fell and gross rent increased, raising the gross rent burden from 29.4 percent to a 25-year record high of 30.8 percent. The increase in monthly gross rents paid by poor households in unsubsidized housing is even more alarming, jumping from \$258 in 1974 to \$359 in 1991.

Higher rents, lower incomes, and fewer affordable units cause serious housing problems for the poor. In 1991, 70.3 percent of all extremely poor renters (those with incomes below 25 percent of area median), or 2.7 million households, devoted more than half their incomes to housing. Almost 2 million households, or 18.5 percent of all very low-income renters (those with incomes below 50 percent of area median) live in structurally inadequate units. Only 28.5 percent of all very low-income renters receive any federal housing assistance.

The production and preservation of affordable housing is critical to alleviating these families' distress. Although HUD subsidy programs and FHA mortgage insurance have contributed somewhat to meeting these needs, there are several areas where HUD's efforts have fallen short of the performance that is desirable and possible.

HUD MUST IMPROVE ITS MULTIFAMILY HOUSING DISPOSITION

A significant but so far missed opportunity exists with regard to HUD's multifamily housing disposition program. HUD's inventory has been growing for several years, and resource constraints and other problems have prevented HUD from disposing of it rapidly and effectively. HFAs can help HUD dispose of its inventory, but sufficient Section 8 subsidy assistance and FHA mortgage insurance are vital to an effective disposition program. Some administrative and legislative changes may also be needed.

HUD's inventory of acquired multifamily properties grew from 22,824 units at the end of Fiscal Year (FY) 1991 to 26,739 at the end of FY 1992. The inventory of multifamily mortgages assigned to HUD grew from 296,675 units at the end of FY 1991 to 321,675 at the end of FY 1992. HUD's FY 1994 budget estimates that this inventory will grow to 383,955 units by the end of FY 1994. The foreclosure pipeline (assigned units subject to foreclosure) is expected to increase from 40,826 to 63,055 units between 1992 and 1994.

The growing inventory of HUD-owned properties is a serious problem with many negative consequences. Chief among these consequences is the blight and social and economic disruption that distressed properties impose on communities. When HUD does not dispose of troubled projects rapidly and effectively, they languish, deteriorate from neglect, and spread that neglect among other properties in the neighborhood.

It does not take long before a few blighted properties cause a downward spiral in a community's housing market and living conditions. Because HFAs have financed and manage properties in the same neighborhoods as HUD, we have a tremendous stake in the success of HUD's disposition effort.

Not only are communities adversely affected, but also the precious housing resource these properties promise is denied needy families. Housing units are not available when their doors and windows are boarded up. Although HUD has the authority to maintain, repair, and sell these properties, its management and disposition process has been severely hindered by limited financial resources, lack of trained staff, and inadequate control systems.

Another serious problem is HUD's failure to act when a project first shows signs of trouble. When HUD does not attempt workouts or foreclose upon troubled properties in a timely manner, delinquencies grow. Owners have little incentive to enter into workout agreements and debt restructuring to bring their mortgages current. They withhold resources from properties, and the properties, when finally acquired by HUD or sold to third parties at foreclosure sale, have more vacancies and greater need for repairs. Then, more Section 8 subsidies or expenditures from the FHA insurance fund are needed to preserve this housing supply.

Aggressive Risk Management Can Prevent Disposition Problems

The three keys to successful portfolio management are sufficient staffing, effective risk management, and approaching a project's needs comprehensively and creatively. The HUD inventory has reached its current distressed state in large part because HUD has not been able to meet these criteria.

HUD is particularly hampered by its severe shortage of staff. Despite the importance of managing and servicing its multifamily loans, HUD does not have the staff capacity to manage its current portfolio. As an example, a recent audit by the HUD

Inspector General's Office found that HUD multifamily loan servicing staff in the Detroit Office are responsible for 105 projects each, in comparison to MSHDA staff who handle an average of 16.5 projects each. The Inspector General found that insufficient HUD staffing contributed to problems in the FHA portfolio. Unfortunately, other HUD offices face similar problems. Without sufficient staff, HUD simply cannot manage its portfolio without outside help. No one could.

Aggressive risk management is critical to preventing losses. In Michigan, we closely monitor our entire multifamily inventory and take immediate corrective action when a property begins to become distressed. Through a computerized system, we review our properties on a regular basis and generate a "watch list" of troubled properties. When a property is designated as troubled, it is removed from the main portfolio and subjected to detailed analysis by senior housing management staff. Staff do a full inspection of both physical and fiscal needs and determine the best course of action to bring the property back to health. By bringing resources to bear when problems first arise, MSHDA greatly reduces the risk of paying substantially higher costs in the future.

The Massachusetts HFA (MHFA), another agency with a highly successful multifamily portfolio, has a similar process. MHFA performs an annual risk analysis which ranks the health of all the properties in its portfolio. A property which collects sufficient risk points is designated as troubled, and MHFA focuses its staff resources most intently on these projects. Rather than following a strict set of identical procedures for each project, MHFA can adapt its level of scrutiny to the needs of the projects. MHFA then works with the owner and management agent to develop an action plan to bring the project back to health.

A key factor in successful management is the ability to move quickly to correct problems. At MSHDA, staff are not constrained by proscriptive regulations but are expected to creatively put together the most effective package of solutions, subject to oversight by the Board of Directors. In contrast, HUD has stacks of handbooks delineating rigid procedures for action. Tied to these cumbersome handbooks, HUD is usually unable to take timely action to correct problems. HUD should put in place systems which allow management creativity, within reasonable guidelines, rather than proscriptive, rigid procedures.

As a result of this aggressive management, MSHDA has had very few properties default. In the rare event of a default, MSHDA would generally sell the property with sufficient buyer incentives, such as Tax Credits, to make it viable. When MSHDA does become the owner of a property, it behaves like an owner, becoming intimately involved in the property to protect its investment in the project's health and prevent deterioration. This prevents the problem often seen in HUD-owned properties of neglect leading to further deterioration and further losses in property value and in the character of the neighborhood.

At MHFA, most dispositions have occurred because the owner took money out of the project for non-project purposes in violation of the regulatory agreements. MHFA then resells the properties as affordable housing, putting together a package of resources as appropriate, such as Tax Credits, Flexible Subsidy, and energy weatherization funds.

HFAs Can Help HUD

Some HFAs are able and willing to share some of HUD's disposition burden. This would allow HUD to concentrate on a more limited universe of properties. HFAs can facilitate the sale of HUD-owned projects by providing different financing options, including Tax Credits and tax-exempt bonds. In addition, HFAs understand the housing markets and needs of their states. They can analyze various properties' specific circumstances and develop effective strategies to deal with them.

Congress recognized the potential of an HFA/HUD partnership in HUD property disposition when it mandated HUD to carry out a program to demonstrate the effectiveness of disposing of HUD-owned properties through HFAs. Under this program, HUD is required to notify a participating HFA of HUD's plans to sell one of its properties and provide the HFA with the option to purchase the property. Four states are authorized to participate.

Since the demonstration was enacted in 1987, however, HUD has not implemented it. Initially, the program was stalled because HUD refused to provide FHA insurance. Later, HUD agreed to provide insurance but declined to offer Section 8 subsidy. HUD still claims that it had little Section 8 to attach to these properties.

Under the leadership of Secretary Cisneros and Assistant Secretary for Housing, Federal Housing Commissioner Retsinas, HUD has indicated that it wants to move forward quickly with this program and will provide Section 8 subsidy to the maxi-

imum extent possible. We are encouraged by these new developments and look forward to getting this program underway.

We cannot say exactly how many HFAs will participate in this program, or other HUD/HFA partnerships, because HFAs across the country have different interests, capabilities, and state needs. For example, the inventory of HUD-owned properties varies greatly from state to state. To take advantage of situations where HFAs are willing and able to work with HUD on various programs, NCSHA seeks to develop as many opportunities as possible, but we do not know which HFAs will actually participate.

Section 8 Subsidy Is Critical For Effective Disposition

NCSHA recognizes that HUD and HFAs that work in partnership with HUD will need substantial amounts of Section 8 authority to preserve long-term affordability of properties under any disposition program. Congress recognized this when it required that subsidies be provided to maintain the affordability of all units in subsidized projects and all units occupied by lower income persons in unsubsidized projects. To comply with this law, HUD must provide 15-year Section 8 project-based subsidies with virtually every sale of a HUD-owned property.

HUD has not requested sufficient budget authority to meet its disposition needs for several years. Even if it had, Congress would have great difficulty meeting the demand for disposition and other housing program funds in this period of severe budget restraint. For example, HUD received only \$93 million in budget authority for FY 1993 property disposition subsidies, enough for less than 5 percent of the units needing assistance at the beginning of the year.

Under HUD's FY 1994 budget, funding for disposition activities would significantly increase by \$160 million to a total of \$256 million for FY 1994, enough for HUD to subsidize 2,245 units with 15-year project-based subsidy. This is twice as many units as the 1,062 units HUD estimates will be assisted in FY 1993; but it is still only two-thirds of the units supported in FY 1992 and only a fraction of what's needed.

We support HUD's request for more Section 8 property disposition subsidy because it is necessary to dispose of the inventory and maintain affordability. We must note, though, that HUD's request will still set an annual rate that will require 14 years and 5 months to dispose of the 32,337 units HUD expects to be in its inventory at the end of FY 1994. This does not count the units that will come into the inventory in future years.

To reduce the need for subsidy, HUD should aggressively discount the sale prices of its properties. Cutting the price of properties will not eliminate the need for subsidy assistance, but may speed HUD sales and reduce the subsidy required to maintain affordability. HUD has the authority to discount prices but has been reluctant to exercise it in the past in part because it hopes to receive a greater return to the insurance fund. However, HUD's holding costs and the costs associated with property deterioration would be reduced by quicker sales, even at reduced prices.

HUD should be given greater flexibility in pursuing a variety of strategies to dispose of HUD-owned properties. Congress and HUD should consider whether providing Section 8 subsidies for 5 instead of 15-year terms would allow HUD to dispose of its inventory more quickly, prevent further deterioration of properties and their communities, and increase affordable housing opportunities. Reducing the Section 8 contract term would allow HUD to dispose of approximately three times as many units with the same amount of budget authority. If the Section 8 subsidies were renewed after the expiration of each five-year term, the units would remain affordable for as long as under the current 15-year term subsidies.

Congress may want to consider also whether to allow HUD to dispose of subsidized properties when Section 8 subsidies are provided to fewer than all of the units in the property. This change would allow HUD to dispose of more properties than it can currently, because HUD could assist more properties with the same amount of Section 8 budget authority. This change would also allow mixed-income use of some properties.

It is crucial, however, that HFAs or other purchasers of HUD-owned properties be given the discretion to request subsidy assistance for as many of the units in a particular property as the HFA or purchaser, in conjunction with State and local government officials, believes is appropriate. This is necessary so HFAs or other purchasers can maintain the affordability of as many units as possible and assist HUD in disposing of properties in neighborhoods where subsidizing all of the units is the only practical method of using the property. In addition, Congress and HUD should give priority to purchasers who intend to keep the maximum number of units

affordable. This will focus limited federal resources on providing housing to those who need it most.

HUD may also be able to use tenant-based rather than project-based rental assistance when HUD and a purchaser agree that such a strategy is workable. HUD should be able to consider demolition and replacement or alternative use of some units or entire properties when HUD, working in combination with a State and local government, decides that such a strategy is most cost-effective and still preserves an adequate supply of affordable housing in the area. Carefully used demolition and creative replacement can play a role in reinvigorating distressed communities and using some units for social services or transitional housing can meet the overall needs of neighborhood residents most effectively.

FHA Mortgage Insurance Is Essential

A serious problem with proposals to provide 5-year subsidies instead of 15-year subsidies is the difficulty prospective purchasers of HUD-owned properties will face in obtaining financing for such purchases. Most lenders will hesitate to finance acquisition and rehabilitation of a project with only 5-year Section 8. The credit risk of meeting expenses without the rental income provided by federal housing subsidies makes conventional financing virtually impossible.

We believe this problem can be overcome by providing FHA mortgage insurance for disposition sales. With federal mortgage insurance, lenders will be able to re-evaluate the risk of loss on the properties and may find it easier to enter into loans to purchase HUD-owned properties, despite the lack of long-term subsidy contracts.

Past HFA/FHA partnership plans, as well as HUD's general disposition efforts, have been foiled by the lack of mortgage insurance for property disposition sales. The FHA could maximize private resources to assist in its disposition efforts by insuring mortgages for HUD-owned properties. These private resources would allow more disposition for less money—an outcome I think we would all support. In addition, providing FHA insurance should reduce the cost of financing disposition purchases, thereby reducing the costs of such purchases to the new owners and, ultimately, to HUD and the taxpayers in the form of continuing subsidies.

We understand the reservations that some might have regarding the increased risk to the Federal Government posed by insuring mortgages on disposition sales. Additional delinquencies and defaults of HUD-insured mortgages would increase losses and throw good money after bad. However, sound underwriting should significantly minimize this possibility, and effective disposition should stabilize communities and protect the insurance fund rather than threaten it.

HUD SHOULD IMPLEMENT THE FHA/HFA RISK SHARING PROGRAM

In addition to assisting disposition efforts, FHA insurance can be used more broadly to produce new affordable housing. FHA multifamily insurance helps produce housing by lowering the cost of financing. For example, with FHA credit enhancement HFAs can receive a higher rating on their bonds, thus lowering the cost of the bonds. These savings are passed directly through to the project, making it possible to finance more, and more deeply targeted or otherwise difficult-to-develop, affordable housing.

Multifamily credit enhancement through private insurers and Fannie Mae and Freddie Mac is virtually nonexistent, making FHA insurance even more vital. Yet FHA's multifamily capacity has decreased dramatically. FHA multifamily insurance fell from \$5.6 billion in 1987 to only \$630 million in 1989 and \$1.7 billion in 1992. Multifamily mortgage originations have gone from almost \$50 billion in 1986 to less than \$24 billion in 1992. In the early 1980s, FHA insured over thirty percent of multifamily mortgages (for both new and existing properties); in 1991, FHA-insured mortgages represented only about six percent of total loan originations. Without the credit enhancement provided by FHA insurance, it will remain virtually impossible to finance affordable multifamily housing.

HFAs play an important role in financing multifamily housing new construction and rehabilitation through tax-exempt bond issues and Tax Credits. Unfortunately, HFAs' ability to issue these bonds is being undermined by the lack of available multifamily credit enhancement. In 1990, HFA new construction and rehabilitation bond-financed programs produced over 228 multifamily projects—over 11,000 units in all, 79 percent of which were rent-restricted. In 1991, HFA bond-financed programs produced 146 projects totalling fewer than 11,000 units.

Tax Credit projects are also falling through for lack of permanent financing. For example, states which require financing to be in place before they will allocate Tax Credits to a project are experiencing lower usage of Tax Credits. In addition, in 1992, 46 of the 53 Tax Credit allocating agencies had \$69.4 million of Tax Credits

returned to them from 1990 or 1991, in large part because the projects were not able to secure permanent financing. (These Tax Credits represent 14.2 percent of total Tax Credit authority allocated in 1992.)

In last year's housing bill, this Subcommittee responded to these conditions by creating a risk-sharing program whereby HFAs and FHA would work together to support the financing of affordable housing. This program will combine the power of FHA credit enhancement with the proven underwriting and long-term loan management capacity of qualified, financially solid state HFAs.

We have been working with HUD to implement this program and are very pleased with the progress HUD is making thus far. Under the program, HUD will enter into risk-sharing agreements with qualified HFAs. These agreements will provide for full FHA insurance for affordable multifamily loans originated by qualified HFAs and for reimbursement to HUD by the HFAs for all or a portion of any losses incurred on the insured loans.

HFAs that are able and willing to accept 50 percent or more of the risk of loss will use their own underwriting standards and loan terms and conditions without further review by HUD. HUD can impose its underwriting criteria and conditions for agreements where HUD retains more than 50 percent of the risk, but intends to allow as much flexibility as possible to HFAs that satisfy HUD's underwriting and loan management standards. Participating HFAs will handle the loan processing and be responsible for managing and servicing the loan, including arranging any workouts or disposing of a property in the case of a default.

Only qualified HFAs will be eligible to participate in the risk-sharing program. A qualified HFA will be defined as a state or local HFA that is designated "top tier" or the equivalent by national rating agencies, receives an "A" rating for its general obligation bonds from a nationally recognized rating agency, or otherwise demonstrates its capacity based on factors such as years of experience in multifamily finance, fund balances, portfolio quality, and administrative capabilities.

Congress provided a total of 30,000 units for the program for fiscal years 1993 through 1995. Applicants will be limited to a share of the total number of units available that is equivalent to their share of the total population of the applying jurisdictions. The population and units awarded to local HFAs will be subtracted from the state totals for purposes of this allocation. We hope that the level of units authorized for this program can be matched to the demand for the program over time.

Funds will be available for a variety of activities, including construction and substantial rehabilitation of affordable housing units. We believe that HUD should also allow HFAs to acquire multifamily properties and perform moderate rehabilitation under this program, because in many cases these activities are necessary and appropriate to provide affordable housing opportunities for lower income persons. In fact, the 1993 report of the Joint Center for Housing Studies of Harvard University states, "The weakness in the rental market also makes this an excellent time to acquire properties that can be added to the permanent stock of affordable housing."

Housing provided under this program will be set aside for low income use in a manner consistent with the Low Income Housing Tax Credit program. We understand that although this targeting is clearly what Congress intended, a HUD General Counsel opinion was necessary because of ambiguity in the Housing Act of 1992. We want to alert the Subcommittee that some further legislative change may be appropriate to eliminate any possible confusion about Congress' intent on this issue.

While some observers are concerned that this program may expose the FHA to default risks, HFAs' high underwriting standards and multifamily expertise make any default extremely unlikely, and should a default occur, HFAs have the assets and commitment to fulfill their obligation to pay. HFAs are governmental agencies with the ability and incentive to assist HUD in their shared public missions of providing affordable housing, without taking undue risks with either their own or federal assets.

The risk of an HFA going bankrupt and failing to reimburse the Federal Government is negligible. HFAs' financial health is a matter of public record and is closely monitored. In fact, as state-chartered agencies, HFAs are subject to scrutiny equivalent to direct regulatory supervision. HFAs are held accountable by boards of directors which typically include high-level state government officials and private sector representatives. HFAs are audited annually, and their operations are closely monitored by national credit rating agencies, such as Moody's and Standard and Poor's, which rate their bond issues.

Based on the processing capabilities of HFAs and the resource constraints of FHA, we also recommend that HUD delegate mortgage insurance processing to qualified and interested HFAs. Such a delegated processing program would enable HFAs that

may not participate in the risk-sharing program to assist FHA to carry out its mission more effectively.

HUD MUST REVISE ITS SUBSIDY LAYERING GUIDELINES

Another way HUD can facilitate the production of affordable housing is to substantially revise its subsidy layering review guidelines for Tax Credit projects and delegate that review to states, as required by the Housing Act of 1992. We are heartened by HUD's indications that it is reviewing the concerns NCSHA and other organizations have expressed about the April 1 draft and earlier versions of the guidelines.

The existing subsidy layering review process is unnecessarily complicated, administratively unworkable, and fails to recognize the legitimate development needs of many projects. Those few projects that can find alternatives to HUD assistance do so to avoid the HUD review. Those projects that can only proceed with HUD assistance often are delayed months awaiting HUD's approval, are abandoned, or are simply not undertaken.

Unfortunately, the proposed revisions in this review process do little to improve it. The revised guidelines do incorporate elements of NCSHA's recommendations, such as replacement of the internal rate of return (IRR) calculation with the net equity approach. However, other recommendations, including some later mandated by Congress through Section 911 of the Housing Act of 1992, are not reflected in the revised guidelines.

Legislation Requires Delegation to Housing Credit Agencies

The 1992 Housing Act requires the HUD Secretary to establish guidelines within which housing credit agencies will carry out the subsidy layering review process. HUD's proposed guidelines provide for a very limited delegation of this responsibility to the states and require substantial agency reporting and HUD review for states to keep it. This is at odds with the legislative intent to streamline the review process and avoid unnecessary delays by entrusting the responsibility for the review to the states.

The guidelines require the agencies to obtain HUD's approval of their underwriting of any projects in which more than 40 percent of the units are set aside for low income use. As most Tax Credit projects have 100 percent of their units occupied by low income families, HUD review would be required in nearly all cases involving HUD assistance. In addition to ignoring the delegation provision in the Housing Act, this requirement will result in a complicated multi-level review process which could delay a project and cause it to miss critical Tax Credit allocation and other development deadlines.

The instructions to HUD Field Offices which accompanied the proposed guidelines outline numerous situations in which a housing credit agency's review authority would revert back to HUD, and require agencies to continually satisfy HUD that they should retain their review authority. For example, a housing credit agency would be required to annually report data on each syndication and refine its schedule of net syndication factors to reflect actual syndications, which would require a huge amount of time and documentation. Such requirements will impose a tremendous burden on both HUD Field Offices and credit agencies alike.

Guidelines Should Allow Reasonable Developer Fee Limits

The proposed guidelines provide that a developer's fee, including an allowance for builder profit, be limited to 10 percent of total development cost unless the project is located in a qualified census tract or exhibits "other special risk characteristics," in which case the fee may not exceed 17 percent. These limitations may be too stringent in many housing markets to compensate for the expenses, overhead, time, and risk involved in developing a Tax Credit project, especially one with multiple layers of subsidy and financing.

Furthermore, the guidelines permit housing credit agencies to approve developer fees in excess of 13 percent only if they develop a "Risk and Related Profit Schedule" which is reviewed and approved by both the local HUD Field Office and HUD Regional Office. In order to deviate from the approved schedule under any circumstance, the housing credit agency must obtain additional Field Office approval. These multiple review and approval processes are unnecessary and will slow or discourage the development of projects with "special risk characteristics."

HUD's limitations and approval requirements are inconsistent with the 1992 Housing Act provision that the guidelines "require that project costs, including developer fees, are within a reasonable range, taking into account project size, project

characteristics, project location, and risk factors, as determined by the housing credit agency." We suggest that HUD establish a reasonable range of developer fees and let the state agencies judge what is appropriate within that range based on their knowledge of a particular project's characteristics.

The NCSHA Board of Directors recently adopted a set of standards for use by state agencies that administer the Tax Credit. These standards, which cover specific areas such as per unit costs, developer fees, consultant fees, cost certification, and compliance monitoring, demonstrate the responsibility and effectiveness that housing credit agencies will exercise in implementing the Tax Credit and the subsidy layering review process. We recommend that HUD promulgate guidelines consistent with these standards.

HUD MUST IMPROVE ITS AFFORDABLE HOUSING PRESERVATION PROGRAM

The last major multifamily challenge that I would like to discuss today is HUD's responsibility and opportunity to preserve the existing stock of assisted multifamily housing for long-term affordable use. This Subcommittee is well aware of the preservation issue, having written legislation in 1987, 1990, and 1992 to establish and refine the legislative framework to guide the federal response to the potential loss of thousands of affordable housing units. HUD faces difficulties in implementing this program and has recently proposed changes to the program that may weaken rather than strengthen the program overall.

In some states, HFAs have already been involved in processing expiring use projects under the Emergency Low Income Housing Preservation Act (Title II) or the Low Income Housing Preservation and Resident Homeownership Act (Title VI). HFAs are eager to undertake processing functions for HUD to ensure the preservation program's success.

HUD Faces Difficulties in Implementing the Preservation Program

Implementation of the preservation program has been slow and difficult. Regulations were published late and in a piecemeal fashion. Training for HUD staff, potential nonprofit purchasers, and owners was negligible. Few projects were actually processed.

We believe that under the leadership of Secretary Cisneros, there is a new opportunity to make the preservation program work. But it faces serious obstacles. HUD program staff at the field office level, who are responsible for processing preservation projects, are heavily overburdened and in many cases have not received the training they need to administer the program effectively. Typically, these staff are responsible for processing rent increases, preservation deals, and several other functions simultaneously. The demands on HUD staff will only increase as more owners file notices of intent. In addition, as properties move from the appraisal stage to applying for financing, HUD staff will need to perform the additional task of Section 241 loan underwriting.

Typical of the delays afflicting the process, HUD is not meeting the statutory time frames under Title II of issuing deficiency letters not later than 60 days after receipt of a plan of action, nor is HUD approving the plans within the required 180 days. Often the delays are attributable to the valuation and architectural engineering branches not providing information to the loan management branch in a timely manner. HUD's contracting process for appraisals, capital needs studies, and environmental reviews has also resulted in significant delays. The complexity of the law and regulations leads to additional delays and missteps as participants in the process attempt to clarify the requirements. It is also critical that coordination within HUD staff and between HUD and outside contractors improve.

The problem is further worsened by the lack of appraisers and capital needs consultants who are fully trained in evaluating projects for preservation purposes. Because Title II and Title VI are driven by the appraisals and capital needs studies, it is crucial that these estimates be accurate. For example, one MHFA project submitted its plan of action in August of 1992 but did not receive a completed capital needs study until March, 1993. When the study was complete, the cost estimates grossly exaggerated the repair needs of the project. The Vermont Housing Finance Agency has encountered a similar problem with a property currently in the preservation process. These inflated rehabilitation needs can prevent owners from obtaining needed equity loans and Section 8 assistance for their projects.

So far, HUD seems to be dealing with preservation projects as a series of discrete steps rather than looking at them comprehensively. Preservation projects should be looked at like any other development project, from the perspective of what they need to survive as low income housing and how the existing resources can be structured to provide maximum benefit. HUD should be focused on results, not on the steps.

HFAs Can Help Relieve HUD's Burden

In light of the need for timely action on the backlog of preservation projects and the new atmosphere at HUD, HFAs intend to work closely with the new administration to establish an effective program under which HUD would delegate processing of preservation projects to qualified, interested HFAs. The National Affordable Housing Act of 1990 authorized such a process, and last year you reinforced that provision by requiring HUD to issue regulations to implement it. Initially, HUD responded only by reopening the comment period on the provision, but providing no further guidance. We believe that the new leadership at HUD will pursue the delegated processing opportunity. Some HFAs which are interested in undertaking full delegated processing are also eager to work with HUD under a risk sharing program.

Through risk sharing and delegated processing, state HFAs can offer HUD valuable service in addressing the growing backlog of projects which may seek preservation incentives. Delegating processing to HFAs would generate substantial administrative cost savings to HUD. These procedures would minimize FHA staff time and allow staff to concentrate on actual underwriting decisions.

Many HFAs are experienced in multifamily development and management oversight, and have excellent track records with regard to underwriting, processing, and maintaining their inventory. Specifically, HFAs have the capabilities and resources to commission and evaluate appraisals, determine costs and capital/rehabilitation needs of a development, evaluate mortgage credit, process mortgage loan proceeds, and cost certify. In addition, HFAs are able to underwrite and process loan applications, evaluate operating budgets, ensure financial compliance, provide tenant services, and develop creative workout solutions. These resources will enable HFAs to process prepayment projects in an expeditious and responsible manner.

For HFAs to undertake this responsibility, it is crucial that we receive sufficient compensation to cover our costs. This could be effectively covered by the combination of a reasonable processing fee from HUD with Section 8 contract administration fees.

Preserve the Existing Federal Cost Limits

We are deeply concerned that the proposal included in the Administration's FY 1994 budget to reduce the federal costs limits from 120 percent of Fair Market Rent (FMR) to 100 percent of FMR will result in the loss of much-needed affordable housing stock in higher cost areas. Although we recognize the pressure on HUD to identify cost-saving measures, we believe the inevitable loss of affordable housing that would result from this change would defeat much of the purpose of Title VI. In Massachusetts, we estimate that 20-40 percent of the eligible inventory would be lost: in two of the three Chapter 13A developments processed by MHFA, the government appraisal exceeds the 100 percent Section 8 FMR.

The federal costs limits are adequate at 120 percent of FMR where the FMRs are consistent with the market. In Boston this is generally the case, although in some suburban areas the FMRs have reportedly not kept pace with values for preservation purposes. As a result, even 120 percent of FMR will not be sufficient to preserve properties in some areas.

Based on the experience so far, many states with preservation inventory expect that few owners will be able to prepay because their properties will fall within the federal cost limits. At this time, these owners are more likely to seek incentives to maintain low income use. However, the number of owners applying to prepay is likely to increase if the federal cost limits are reduced.

Technical Training for All Participants is Critical

We believe HUD and the Congress must provide adequately for technical training for HUD staff, HFA staff, contractors such as appraisers and capital needs consultants, potential nonprofit purchasers, residents and owners. We would suggest, for example, that HUD open the 30 preservation training sessions it plans to sponsor around the country to HFA staff and other participants in addition to resident groups and community-based nonprofits.

In summary, we intend to work with HUD to develop effective delegated processing and risk sharing programs with HFAs. These programs would benefit HUD by minimizing the risks to HUD compared to full Section 241 insurance, ensuring timely and efficient processing of plans of action, and reducing the workload on HUD staff.

Although this country is experiencing serious multifamily housing needs and HUD faces specific and difficult programmatic and administrative challenges, HFAs

sense a great opportunity to work in partnership with HUD to meet these housing needs and overcome these challenges in our joint efforts to increase affordable housing opportunities for lower income persons. Thank you.

TESTIMONY OF RONALD RATNER

PRESIDENT, FOREST CITY RESIDENTIAL DEVELOPMENT, INC.

Mr. Chairman, my name is Ronald Ratner.

I am President of Forest City Residential Development, Inc. and Executive Vice President of Forest City Enterprises, Inc., which are headquartered in Cleveland, Ohio. Forest City is a publicly traded corporation, with over \$2,000,000,000 in real estate holdings across the country. Our multifamily portfolio includes an ownership interest in over 32,000 apartment units, in 18 states, and over 100 communities, ranking us the 19th largest owner of multifamily real estate in the country. Our company also manages more than 24,000 apartment units in 15 states and over 80 communities, which makes us the 34th largest manager of multifamily housing.

Our participation in HUD and FHA programs began in the 1940's, with the development and ownership of a Section 608 property and has continued through virtually every multifamily program. We currently own 2,100 units of conventional, unsubsidized properties that are FHA insured, and 12,200 units in properties that receive federal assistance.

Through an affiliate, Forest City Capital Corporation, we are also an originator and servicer of FHA insured loans. We have originated over \$200 million in such loans over the last 20 years and currently service \$135 million in insured loans.

We have been leaders in housing production programs as well. Subsequent to our successful participation in HUD's Operation Breakthrough in the early 1970's, we built over 45,000 units of assisted housing for ourselves, others for profit owners, non-profits, and Public Housing Authorities.

We are proud of our record of participation in HUD programs and the affordable housing in both conventional and assisted properties that we have built, owned, managed or financed. While representing only a third of our multifamily portfolio, these units are representative of our company's strong commitment to helping address both housing needs and urban issues. We are also a leading national developer of major mixed-use urban projects in Cleveland, Detroit, Chicago, Pittsburgh, Los Angeles, Brooklyn, New York, Cambridge, Massachusetts, Charleston, West Virginia, and other cities. These projects provide jobs, housing, and economic opportunity, and have proven to have positive economic return in spite of their high level of risk and complexity.

Our multifamily portfolio is performing well and is in excellent condition, but we have not been immune to the current crisis in our industry. Two properties, representing less than 2 percent of our portfolio, are troubled HUD insured assets.

I am honored to have been invited to participate on this panel. I am also here today on behalf of the National Multi Housing Council (NMHC) and the National Apartment Association (NAA). NMHC and NAA work closely together for an economic and governmental environment that supports quality, accessible and affordable rental housing. I serve as a member of their Joint Legislative Committee. Members of these two associations own and manage about one third of the nation's 24 million rental housing units.

NMHC represents the country's larger and most respected multifamily rental housing firms. They are highly sophisticated corporations, many of which own or manage many thousands of rental units. Its members are engaged in all aspects of the development and operation of rental housing including the ownership, building, financing and management of such properties.

NAA brings together state and local associations of owners, builders, investors, developers and managers of multifamily properties. It provides education and training for the multifamily industry and works on local, state and national legislative issues. It represents more than 200,000 multifamily professionals who own and manage over 3.5 million apartments and condominiums nationwide.

Therefore, I speak from personal experience and frustration, as an industry spokesman, and as a citizen concerned with a real threat to our national commitment to affordable housing.

Multifamily rental housing, while addressing the needs of all Americans, has historically been the major housing alternative for low and middle income families. This important contribution of our industry has been augmented and facilitated by HUD, through both its mortgage insurance programs, and its assisted or subsidized housing programs. While our purpose today is to focus on the disposition of the distressed component of HUD's portfolio, we should not lose sight of the successful role

that HUD has played, and must continue to play, in the moderate cost multifamily market. Many thousands of families live in safe, modern affordable housing as a result of that role.

In addressing the troubled project dilemma that faces HUD, I wish to establish four (4) points before drawing a conclusion:

(1) The scope of the troubled HUD inventory, and the management, financial and human complexities involved is staggering. The GAO report delivered to the House, HUD's own audit, and the other surveys reported in *The New York Times*, detail over 65,000 units now in inventory, and a cost in the billions to dispose of these assets. As stated by Chairman Gonzalez in the House hearing on this subject, "the Federal Government is in 'property disposition gridlock'". Policies, procedures and law evolved during normal times cannot cope with a crisis of this magnitude. We must take strong, immediate action.

(2) The current inventory of troubled HUD properties represents only a fraction of the potential problem. Regardless of the success of any method that HUD uses to dispose of its existing inventory of such properties, the Department must take aggressive action, with congressional and industry support to prevent additions to its inventory from further defaults. This issue can only be addressed by major changes in HUD's workout and foreclosure strategy and regulations. HUD must be allowed and required to follow the example of private lenders, and either take assertive foreclosure and disposition action, or negotiate meaningful workouts that actually do work to restore project viability.

For example, HUD requires that a workout plan demonstrate that a project can be brought current on its payments within 3 years and can then carry a recast loan at the original rate, including accrued interest as additional principal. In today's distressed market, any property that needs only such limited help is not likely to be in real trouble. Even if all parties agree that a workout would best serve HUD, the borrower, the tenants and the community, the three year limitation prohibits any meaningful relief.

Current government policy also prohibits HUD from writing down a loan. Even when a good borrower has maintained the asset, and invested heavily in it, but the market condition has deteriorated and the asset has lost value, HUD cannot avoid the further loss in value from foreclosure, HUD management and sale.

A good workout plan requires a well managed asset, a realistic restatement of the debt, a commitment by the borrower to invest time and money in the asset, and a sharing by borrower and lender in any recovery in value. Simultaneously, HUD must vigorously pursue foreclosure if the requirements for a workout cannot be met, and must rigorously pursue criminal and civil penalties for borrowers who violate the Regulatory Agreement and divert project cash flow for their own needs.

These changes will require revisions in law, and OMB or Treasury policy, as well as assertive action by HUD.

(3) We must reconsider the low income housing preservation requirements of the Housing and Community Development Act of 1987 in light of the current onslaught of troubled HUD-owned properties and HUD-held mortgages, their significantly distressed condition, and the major allocation of limited low income housing funds that the requirements dictate. Numerous experts, including the GAO, project that it will require 3 to 4 billion dollars in project based Section 8 authority to meet the statutory requirement to preserve low income housing. Yet, what are we preserving? The HUD-held previously assisted stock is, by definition, severely troubled real estate. The long process of distress, default, foreclosure and disposition accelerates the deterioration.

When sold with project based Section 8, these properties are often worn out and in substandard condition, outdated in design, and poorly located in reference to jobs, schools, and transportation. The repairs required upon sale are inadequate to restore long term stability. If we continue to mandate the false goal of preserving such low quality housing, we will have backed into a major housing program that will perpetuate substandard housing and lock tenants into deteriorating units. The only rationale for putting major new resources into such poor quality housing is that the funds would never be allocated unless forced by circumstances. The requirements of an Act crafted in relation to the very different scope of the problem six years ago should not be allowed to become a self-defeating constraint today. The intent of preserving and enhancing low income opportunities can be met in more effective ways.

(4) HUD must change its policy and deal directly with the problems resulting from the coinsurance program. In an attempt to distance itself from what was a massively flawed initiative, the previous administration applied a rigid policy of willful neglect to coinsured, or previously coinsured loans. Simple relief provisions such as temporarily waiving fees, replacement reserve deposits, or principal payments are routinely granted for fully insured projects and not even considered for

coinsured loans. A coinsured loan should not condemn a property, its owners, tenants or neighborhood to a life in administrative purgatory. The assertive, creative workout/foreclosure program I have recommended should be appropriately applied to coinsured loans. This is simple, and any other approach results in self inflicted wounds for HUD, and the insurance fund.

Before proceeding to my conclusion, I would like to offer a housing practitioners view of the historical dynamics that have, in my judgment, led to the high default and loss rate in the HUD portfolio.

As originally constituted, the FHA multifamily insurance programs were intended to provide access to the capital markets for producers of moderate cost rental housing. Under a variety of well structured programs, thousands of units were built in hundreds of communities in the 1940's, 1950's and 1960's. As FHA was absorbed into HUD in the late 1960's, the strategic focus of the Department moved more and more to low income, assisted housing and fewer moderate cost projects were underwritten. Assisted loans, supported by below market interest rates, direct rental assistance, or other devices began to predominate the portfolio. Further, many of the remaining market rate loans were underwritten for higher risk projects in urban revitalization areas, and other areas of higher need. HUD, with congressional, industry and tenant urging, directed its efforts to where the private sector could not or would not go.

Underlying this shift was an unforeseen, latent underwriting flaw. A lower income resident in most markets across the country, can only afford to pay rent that is, at best, roughly equivalent to the operating cost of the rental unit. No dollars are available to apply to capital charges. In effect, the full cost of the physical asset; interest, principal, fees and capital replacements, must be subsidized. In one way or another, this has been the intent of every housing assistance program in at least the twenty-five years of my personal experience. Operating costs however, even if covered by the tenant's original contribution to rent, have risen faster in periods of high inflation than the earnings of lower income families. Over time, and in a slow inexorable progression, the tenants and owner are squeezed by higher relative housing costs, the subsidy is fixed, the property runs a deficit and defaults. This dynamic creates, and in turn, accelerates the physical deterioration resulting from unmet capital replacement needs. In mixed income properties, in periods of low inflation, or with increasing subsidy, assisted housing can be self sustaining. Otherwise, it must end up in distress, regardless of how well managed or underwritten.

This unavoidable flaw, combined with the shift in FHA activity to more assisted loans, and away from middle market loans, underlies the seemingly high failure rate. As a result of this shift in direction years ago, FHA does not have the cushion of insurance and origination fees from middle market properties to help absorb its other losses, the middle market developer does not have access to affordable capital, and does not build for this market, and the middle income tenant is without affordable housing choices. If we are to assist in bringing the FHA insurance fund back to health and allow it to continue a reasoned program of low income assistance, we must also allow FHA to re-enter the middle market. An insurer cannot continue indefinitely to insure high risk loans at below market premiums, and stay solvent.

It is against this background that we must consider the solutions to HUD's troubled and owned portfolio.

A much overworn cliché is "when it ain't broke, don't fix it". In application to our discussion today, we must add a corollary, "if it is broke, don't tinker with it, change it". The incremental, business as usual, approach followed in prior years cannot begin to address the problem. A response to any of my four points, let alone all of them, requires a total change in HUD's policies and management, changes in law, and in related areas of government policy. We must get out in front of the issues and create a new concept and strategy to achieve a quick and lasting solution.

My conclusion, however, is that HUD, operating within its current structure, beset by years of reduced staffing, low morale, and facing a problem of staggering scope that has been accumulating for years, cannot cope with the issue.

I recommend a major shift in resource allocation and a clean break with existing policies and regulations by the creation of an independent Recovery Bank within HUD. This would be modeled after the "Good Bank/Bad Bank" structure successfully utilized by other lenders to deal with their troubled portfolio. The goal of this process would be to shift full responsibility for the HUD-held and troubled loan inventory to a new group of actors, with a mandate to create new policies and programs appropriate to the challenge. The senior executives responsible for the Recovery Bank's activities would have a limited time to report to a Congressional oversight committee on the programs and policies required to quickly and fairly dispose of the assets.

In many ways, the Recovery Bank would function like the RTC, and would be a self-liquidating organization. This new entity would be able to take actions such as:

(1) Establishment of a well conceived program to monitor troubled loans, and identify projects that should be targeted for workouts prior to default.

(2) Creation of a rational workout policy in line with the prior discussion and described in greater detail in the attached letter previously submitted to Secretary Cisneros by a NMHC/NAA task force.

(3) Aggressive pursuit of foreclosure where called for, and strict enforcement of regulatory requirements to preserve project cash flow prior to foreclosure.

(4) Bulk sale, where feasible, of non-performing loans. The distress in the real estate market has provided the private sector with experience in dealing with troubled loans. The RTC and others have created vehicles to dispose of troubled loans.

(5) Separation through workouts, partial assignment, or other methods of a performing mortgage piece and a non-performing accrual component. This would allow sale of the performing mortgage directly or through reissuance and a recovery of funds.

(6) Even-handed treatment of coinsured loans. A loss by any other name is still a loss.

(7) Reissuing mortgage insurance. The Recovery Bank could take advantage of the current low interest rate environment to reissue insurance on previously assigned loans where the rate at the time of default created a non-performing situation. A default two years ago of a loan at a 10 percent rate should not preclude the reissuance for what could be a performing loan at today's rate of 7.5 percent. Today's low rate market creates a refinancing window which can tremendously mitigate HUD's loss.

(8) Careful consideration of floating rate alternatives in light of today's steep yield curve.

(9) Triage of the HUD-held inventory of assisted property. Permanently substandard or blighted property should simply be demolished. Low income tenants should be given tenant based Section 8 certificates. Viable properties could be transferred to appropriate owners, possibly through local or state HFA's or directly to non-profits, or limited dividend for-profits. Where market forces dictate that a low income project will stay low income without elaborate mechanisms, simple sale can be considered.

These and many other strategies can be used to quickly resolve the problem. They are best accomplished by a newly constituted group, free to create solutions that are equitable, workable, and cost effective. HUD itself would then be able to refocus its energies on the correction of its internal management deficiencies, and the challenge of providing for the continuation and enhancement of its many sound programs.

It is time to put the financial failures of the 80's behind us. While paying close attention to their lessons, we must proceed to allow our financial institutions, led by Secretary Cisneros and HUD, to provide new sources of capital for low and moderate income housing.

HUD Handbook 4350.1 prohibits HUD officials from entering into a workout for projects unless the owner brings the mortgage, including all arrears, current within three years. That Handbook provision has forced HUD officials to make decisions that cause enormous waste of scarce public resources. Although HUD has occasionally granted waivers to this Handbook provision, rigid application of the provision has caused HUD to reject sound workout proposals where developers were prepared not only to put millions of dollars in improvements into a property, but also to maintain the properties for low and moderate income tenants without new subsidies. When the Handbook strictures caused HUD officials to reject sound workout proposals, the result was for HUD to take on the ownership of properties, spend millions of dollars to make necessary repairs, and then sell the projects with costly Section 8 subsidies to induce other developers to purchase the projects.

HUD Acquisition: taxpayer losses and community disruption

Numerous studies by Congressional committees and the General Accounting Office have long documented that, after foreclosure and acquisition by HUD, the result is needless cost to the taxpayers, deterioration of property and disruption to residents. See Report on Management and Disposition of the Department of Housing and Urban Development's Inventory of Multifamily Properties, submitted by the Investigations Staff, Committee on Appropriations, to the Subcommittee on HUD-Independent Agencies, U.S. Senate Report No. 75-10, 96th Cong., 1st Sess., 18-20 (1979).

In recent years, HUD has routinely responded to troubled projects in ways that have absurd results for the long-term interests of the government and the public. Many industry practitioners have encountered a number of disturbing examples.

President Clinton's HUD transition team reportedly found that, at the end of 1992, the inventory of HUD-held mortgages that were delinquent and not in workout included more than 790 projects totalling as much as \$3.7 billion, while only eight HUD-held projects totalling about \$27 million were in workout. Those figures do not take account of many other troubled projects, including those financed under the Coinsurance program and those that have not yet been assigned to HUD.

There are several reasons why HUD's management in recent years made perverse decisions with respect to troubled loans. One reason was the belief that HUD personnel lacked sufficient expertise to negotiate workouts. Another reason is that, although prudent workout strategies would save the government tens of millions of dollars, the costs related to workouts would be borne early in HUD's budget, while the costs of doing nothing would be borne by the Treasury and by subsequent administrations.

An available solution: prudent workouts

The government could realize great savings if HUD were to make careful use of workouts and mortgage modifications to restore the economic viability of projects and to preserve low- and moderate-income housing.

If HUD does not have the proper staff to conduct workout negotiations, the Department could use sensible alternatives that have been well tested in practice by RTC and other agencies.

The details of a workout strategy should be established in a way that builds an awareness in Congress and the public of the costs of past inaction. Procedures could be carefully designed to ensure that (1) workout negotiations occur at arms length, (2) the long-term interests of the government are protected, (3) any diversion of project cash flow in violation of the regulatory agreements is prohibited and penalized, and (4) HUD officials are insulated from criticism regarding the details of individual project workouts.

We believe a responsible strategy would include the following elements.

First, the Handbook should be amended to establish simple procedures that allow HUD officials to use the least costly reasonable alternative to further the goals of the National Housing Act - even if that involves a workout that brings the mortgage current beyond three years.

Second, HUD should determine, on the basis of the current mortgagor's performance, whether it is in the long-term interests of the public and the residents for the current mortgagor to continue as the owner/manager of the property.

Third, if it is determined that continuation of the current mortgagor would be in the interests of the government and residents, HUD should have a straightforward procedure for designing a workout. Such a procedure could include four steps:

1. Determine the amount of hard debt that is supportable by the project revenues.
2. Determine an appropriate contribution of equity that the owner should make;
3. Design a second mortgage for the amount equal to the remaining value of the outstanding mortgage, providing for payments out of a reasonable percentage of cash flow after payment of project expenses and the first mortgage;
4. Analyze the full, long-term government costs both of foreclosing and of restructuring the debt as noted above to provide economic viability for the project; and
5. Choose the course of action that is the best, most cost-effective alternative from the point of view of the government and the public interest.

Applying market tests to loan sales

So that the Department can get about its real mission, HUD should, as promptly as feasible, get out of the business of trying to administer burgeoning inventories of troubled loans. That could be done in a number of ways that draw on the lessons of the RTC and

other agencies. In general, HUD should work toward making these troubled loans salable into the secondary market. By selling HUD-held mortgages to other mortgagees, perhaps using the facilities of GNMA, HUD could soon return millions of dollars to its FHA Insurance Funds.

Techniques that should be explored include:

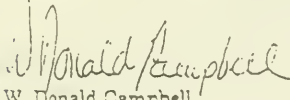
- (1) SWAT Teams - HUD could assemble consulting teams, as the RTC did with its SWAT teams, including a real estate expert, lawyer and government official to negotiate the sale of multifamily mortgages at the best market price available, without a formal competitive process. The SWAT team could be given authority to make final decisions in approving workouts.
- (2) Bulk Sales - Bulk sales of nonperforming FHA mortgage loans could take advantage of the enormous market that the RTC has created for such products. This would allow for the ultimate decisions regarding workouts to be made by experienced private sector participants. Buyback of a loan by the defaulting mortgagor should be prohibited to avoid any appearance of impropriety. State and local housing finance agencies could become priority purchasers in such bulk sales.
- (3) Reassignment to GNMA - HUD could implement the FHA-GNMA Memorandum of Understanding which would permit HUD to reassign formerly coinsured loans to GNMA and allow for a reduction of interest rates to the lower levels now existing in the market.
- (4) Sale to other lenders - HUD could sell mortgages to lenders other than the assigning mortgagee. OMB policy, which was never formally adopted by HUD, has for many years precluded FHA from achieving the best possible market yield.
- (5) Repackaging mortgages - The HUD-held mortgage instrument could be split into a performing first mortgage, which could be financed at lower rates and then sold in the marketplace to achieve a return to the insurance fund, and a second mortgage, which HUD could hold or structure for sale, with specified repayment terms based on how the project performs over a defined period of time.

Other troubled projects with HUD mortgage insurance

Because HUD is at great risk of paying hundreds of millions of dollars in mortgage insurance claims on projects that have not yet gone into default, HUD should establish careful monitoring of troubled project loans and work with mortgage lenders to avoid defaults. The existence of federal mortgage insurance frequently leads banks to direct their greatest attention to other problem loans that are not backed by the government. Intervention by HUD for this category of loans could save HUD hundreds of millions of dollars in the years to come. Prompt implementation of Title IV of the Housing and Urban Development Amendments of 1992 would provide significant public benefits in this regard as would Congressional approval of your budget request for increased funding for preservation and flexible subsidies.

Members of the National Multi Housing Council and the National Apartment Association include many of the nation's leading multifamily housing professionals. We deeply appreciate this opportunity to share our views with you. We would be delighted to work with you and others to help develop a sound public strategy for bringing this problem under control.

Sincerely,



W. Donald Campbell
Senior Vice President for Government Affairs

For the Task Force:

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Nicolas Retsinas

TESTIMONY OF DAVID A. SMITH
PRESIDENT, RECAPITALIZATION ADVISORS, INC.

Preservation: Troubled Properties and Workouts

Mr. Chairman, I appreciate this opportunity to present my views on the issues involved in HUD's troubled multifamily properties and how to maximize results with the least possible cost to the Federal Government.

BACKGROUND AND CREDENTIALS

I have over 17 years direct experience in workouts of HUD-insured affordable housing properties and have worked with Section 236 properties almost as long as they've been around.

- From 1975 through 1981 I personally worked out dozens of Section 221(d)(3) and 236 HUD and state HFA properties which became troubled as a result of the 1974-76 double shock of the Arab oil embargo and consequent rises in fuel costs, and the recession and runaway inflation which drove up costs at the same time that it drove down renters' ability to pay. From that debris emerged property-based Section 8, which is still the most successful and effective means of stabilizing affordable housing properties.

- From 1981 through 1984 I resyndicated many properties financed under these same HUD programs. This involved taking the better Section 221(d)(3) and 236 properties through Transfers of Physical Assets (TPA's); many of them received some renovations as a result.

- From 1985 through 1989 I was involved in syndicating Low-Income Tax Credit (LITC) properties.

- In 1989 I started my own firm, Recapitalization Advisors, Inc., which works with owners of LIHPRHA-eligible Section 221(d)(3) and 236 properties. I was active in the legislative debate surrounding ELIHPA and LIHPRHA. Our company now represents about 205 properties totalling 28,500 apartments throughout the country.

Thus I've negotiated a great many workouts in a wide variety of financial and operational environments, and have seen which of those workouts succeeded and which have failed. I've also followed HUD-financed properties through their entire cycle, from construction to ultimate LIHPRHA/ELIHPA preservation.

THE DEPARTMENT'S APPROACH TO WORKOUTS

At present, the Department's approach to troubled properties seems to be grounded in two principles:

- Either restore the property to full debt service and pay all arrearages within three years (as provided in Handbook 4350.1), or immediately foreclose.
- When in doubt, exercise no judgment. Follow the rules to the letter.

These rules thwart intelligent administration of a loan portfolio. Just as every unhappy family is unhappy in its own way, every troubled property is unique and every workout is unique. All workouts follow similar principles, but all of them involve an enormous number of judgments. Some of those judgments will inevitably be wrong. An organizational culture which severely chastises wrong judgments produces a generation of administrators who make no judgments.

It's easy to foreclose. But foreclosure usually produces poor results.

Foreclosure takes no thought whatsoever. It looks aggressive on reports. A property listed as 'under foreclosure' evokes no questions in periodic reviews, whereas one 'in workout negotiations' is subject to endless second-guessing. I know from personal experience in many contexts that the farther an executive is from a troubled property, the more that executive demands the unilateral solution. (The Department is no worse and no better than banks, insurance companies, or other financial institutions. In large organizations with committee-style oversight, pressure for decisive action is overwhelmingly powerful—even if that is nonsensical.)

At present, the Department is doing almost no workouts. So the properties move from troubled to default, from default to assignment, from assignment to foreclosure, and thence into the Property Disposition inventory. There they sit.

As the property slowly moves through the administrative maze, nothing is done to address its physical condition, so that by the time it is a suitable candidate for disposition, the problem is now often much worse than it was when the original owner was trying to do a workout.

Let me emphasize in this testimony that I am not criticizing individual executives with the Department. For more than a decade the Department has been operated as an Administration backwater suffering alternately from neglect or abuse. Too many decisions were based on how they would look rather than whether they made economic or policy sense.

The time to reverse such trends, and to implement a Department committed to objectives and results rather than mindless caretaking, is now.

TRUBLED PROPERTY WORKOUTS WITH HUD

Reorienting HUD's approach to troubled properties involves five steps. Each is useful on its own, but they will be much more effective if combined.

1. Install a New Approach for Structuring Workouts

Attached as an addendum is a detailed eight-step program for evaluating and then acting upon troubled properties, whether insured or HUD-held. The steps are:

Step 1. Assign a capable workout coordinator.

Step 2. Determine what the real estate needs.

A. Physical improvements.

B. Operational changes.

C. Financial changes.

Step 3. Evaluate the ownership entity's capabilities.

Step 4. Evaluate foreclosure from the government's perspective.

Step 5. Decide whether to foreclose or work out.

Step 6. If workout is superior, negotiate fair contributions.

Step 7. Fund the remaining needs.

Step 8. Recapitalize arrearages in a non-foreclosable way.

An extensive discussion which gives substance to these noble objectives is given in the addendum.

The Department should adopt a workout approach similar to this.

2. Assign Enough Resources to Do the Job Right

A workout done wrong is worse than no workout at all. Critical to the success of any loan management program is providing enough capable executives. Staffing must be addressed.

I am certainly not the first witness to recommend increasing HUD staffing in a variety of areas, but the point deserves frequent and emphatic restatement: HUD is woefully understaffed in real estate workout expertise.

The Department must obtain more and higher-quality staff devoted exclusively to loan restructurings.

Aside from increasing staff, the Department must provide support and a new spirit in field offices. The work environment in many field offices actively discourages capable people from staying at the Department and burns out those who do stay. Walk into any field office and examine the work environment of a typical loan servicer. Evaluate the workload, the working conditions, and the prospects for personal satisfaction in a job well done.

People work harder if they know they are making a difference and if they can see that their contributions are appreciated. All too often, the work environment in HUD field offices sends exactly the opposite message. Small wonder, then, that for more than a decade, many of HUD's best and brightest have left to work in the private sector, where the rewards (both financial and psychological) and more reflective of their abilities.

Compensation and promotion for loan servicers should have performance incentives based on restoring properties to viability. Properties foreclosed should not be a negative, but successful restructurings should be a positive.

About twelve years ago, the Department experimented with regional workout coordinators who were in the main outside individuals contracted to provide help to field offices on their troubled properties. While experience with the coordinators varied greatly, the concept is a good one: a team of workout experts who are available as a resource to aid field offices in evaluating properties, negotiating proposals, and granting authority to the field office to consummate a sensible workout—in effect, an extension of Headquarters' decision-making capabilities into the field so good decisions can be made more efficiently.

The Department should develop an 'on-call' regional workout coordinator function, available to assist field offices when requested in evaluating, negotiating, and securing Departmental approval for workouts.

3. *Change the Criteria for Evaluating Workouts*

HUD's current workout approach asks the impossible and forecloses if it cannot be achieved within three years. Instead *the Department should revise its criteria for evaluating and approving workouts to three simple but hard-to-prove tests:*

- "Will the workout fix the real estate?"
- "After the workout is implemented, will the right people be in charge of the property?"
- "Does the workout cost the government less than foreclosing?"

If all three answers are Yes, implement the workout. If not, foreclose.

Obviously, Handbook guidance on workouts will have to be revamped to accommodate these principles.

The Department must also develop a much better analytical capability. HUD currently does not know what is feasible in a property, what a foreclosure would cost, what HUD could obtain on an as-is resale, what HUD could obtain on a post-renovation, post-subsidy resale, whether LITC's might be available to help a property, and what other non-Federal resources could be brought to bear on the troubled property.

Much of this analysis could be computerized. In the private sector, we use a wide variety of spreadsheets and other customized analytical tools to help us evaluate options. Even with all this support, we spend large amounts of time figuring out what a property is worth under a variety of assumptions. (Quality financial analysis is indispensable for any workout; bad analysis is worse than no analysis.) By contrast, HUD field staff are too often limited to check-box or hand-calculate pre-printed forms.

The Federal Government could hire experts to build financial analytical tools that could be used by field offices and workout coordinators.

However, all spreadsheets, check-box systems, and analytical tools are just that—tools. They do not substitute for judgment and they do not eliminate the absolute, fundamental necessity of individual executives making individual decisions. To that end, *the evaluation criteria for field officers (both written and de facto) must be changed to reward innovation, enterprise, and effort, rather than box-checking.*

In this context, the chilling effect of Inspector General audits has to be mentioned. No one can be opposed to independent review of governmental activities. But after-the-fact review of loan restructurings can always find a judgment that looks foolish—in workouts, many judgments can easily be made to look foolish, even though they were, most of the time, the best possible given the information known.

In general, the people with the most experience in real estate are also those who have made the most mistakes (and learned the most from them). If you don't make mistakes, you're not trying hard enough. Any Inspector General audit must recognize the distinction between corruption or incompetence, which are to be rooted out and eliminated, and simply judging wrong, which is an inevitable occasional consequence of doing anything difficult.

4. *Become More Aggressive in Dealing With Deficient Managers and Owners*

The Department must become more aggressive in dealing with deficient managers and owners.

I offer this recommendation with trepidation—in recent years, all too many managers and owners have already been unfairly bashed by the Department—but the reality is that the Department, though it may huff and puff, very seldom takes actions to which it is entitled, of which the most significant is firing managers.

A. Deficient Managers. Every HUD management contract provides that HUD may terminate the manager at will for non-performance. Yet, in more than 17 years working on HUD affordable properties, I can remember only a tiny few occasions when HUD acted, even when the abuses were egregious and downright criminal. I can remember more when the abuses continued for many years.

The Department should compel the removal of property managers who have demonstrated that they are not up to the task. Weeding out the worst 1 percent will send a message to the industry that will have a salutary effect on the entire portfolio.

Equally important, in many difficult but not yet troubled situations, the Department should be much more aggressive in demanding improved performance from managers who are flouting HUD's rules or neglecting the property.

There is a very competitive market for property managers. The private sector has no hesitation about changing managers when performance is unsatisfactory. The Department must become much more aggressive in holding managers accountable, not necessarily for the condition of their properties, but at the very least for their performance on the job given the resources available.

B. Deficient Owners. Owner general partners are not so easily removed from control of properties; the Department has no rights to remove general partners. Also, under the Uniform Limited Partnership Act, limited partners may not take control

of the business,' which in practice is what compelling substitution of general partners is considered to be. Thus substitution, which is an effective method for dealing with managers, is generally unavailable when it comes to the controlling general partner.

At the same time, the Department can be more aggressive about documenting performance it considers unsatisfactory. It can be more assertive about compelling owners of delinquent properties to undertake evaluations of the property's problems and to come forward with potential workouts. (Owners will be more receptive if they become convinced that this is a meaningful exercise that will lead to workouts, rather than an exchange of accusatory correspondence.)

Finally, in extreme cases, the Department can also exercise the right to become mortgagee in possession, as we have frequently seen state HFA's do. Becoming mortgagee in possession can stabilize the real estate and compel the ownership entity to address the issue of its controlling general partner.

C. Administration of Previous Participation. There is a corollary to this approach: *the Department should restructure its Previous Participation clearance so as not to penalize large owners who take on difficult properties.* As Previous Participation is now structured, owners of many properties almost always have a 'flag' up from one area office or another. The flag goes up automatically if the property is troubled. The larger the portfolio, the greater the certainty of having an outstanding flag. Almost no field judgment is being applied in whether to raise a flag, and I have seen instances where I believe it was used capriciously by individual loan servicers.

Previous Participation must be judged as a whole; on balance, is this owner doing a capable and credible job? If Previous Participation is used, as it has frequently been, on a no-flags basis, the most capable owners—those with the largest commitment to affordable housing—are those who have the most trouble with the Department. This sends exactly the wrong message to the industry.

5. Develop Funding Mechanisms Which Recognize That Protecting the Asset is a Worthy Objective in Itself

A. Rethink Section 241(a) Supplemental Loans. Right now the Section 241(a) supplemental loan program is so cumbersome, and its conditions so impossible to satisfy, that it is almost a complete waste of time. *Either Section 241(a) must be revamped or an alternate workout funding mechanism must be created.*

A Section 241 supplemental loan can be made only when one of two conditions exist. Unfortunately, both of them are impossible:

- Increased rents in the marketplace. Given that the property is troubled, no underwriter (especially in the current, by-the-book environment) is willing to sign off that the necessary rent increases will be attainable in the market.
- Increased subsidy. The current NOFA procedures for allocating Section 8 are broad-based, rather than being responsive to individual property needs. As a result, it can be very difficult to match scarce Section 8 resources with workouts that depend on it for survival.

The systemic flaw in Section 241 as a workout tool is the underwriting assumption that the loan must stand on its own merits. That's not the point. The point is to protect the enormous investment that the Federal Government already has in its troubled property. Given this, HUD should create a funding mechanism which recognizes that a cash infusion, *if it fixes the property's problems*, is worthwhile even if the loan's repayment is deferred or theoretical.

Money advanced by HUD to a workout should be thought of as equity, invested to protect other equity.

In this context, Flexible Subsidy was an effective program. It had a matching requirement (so it brought forth an owner contribution), and repayment was not the primary objective. Originally Flexible Subsidy was targeted only to non-assigned properties (so that it was directed in situations where assignment could be prevented). Of public policy importance, Flexible Subsidy loans carried with them an obligation by the owner to sign a Use Agreement restricting the property's future residual potential.

Flexible Subsidy worked for its designed purpose: saving properties and protecting HUD. Increasing Flexible Subsidy appropriations makes sense.

B. Continue to Develop Partial Assignments. Often a workout may be structured which fixes the real estate, improves operations, protects the residents, and puts the property on a stable footing for the future, but only at a cost of lowering the amount of debt service the property is able to carry. In such circumstances, the Department has in a few instances used the partial assignment procedure to bifurcate the original mortgage into a reduced first mortgage, with a new 'soft' second mortgage that is payable solely from available future cash flow.

This structure is very useful in workouts—indeed, among conventional property restructurings, it is used in the majority of cases. The reason is simple: new money will flow in from the owners and limited partners only if they are confident that the property will not be foreclosed. This can be made more certain if the mandatory portion of debt service is lowered.

From the Federal Government's perspective, a partial assignment is superior to a complete assignment (because there is less of a claim on the FHA insurance fund), even if no contributions come from the owner. A partial assignment that also brings forth other resources is doubly superior to assignment.

Once the soft second mortgage has been created, the Department should be incentive-oriented in structuring the sharing of future cash flow. Giving, say, 25 percent of the cash flow to the owner is often a wise investment because it creates an incentive for the owner to maximize cash. When the Department receives 100 percent of the cash flow, the owner has no incentive.

Partial assignments should continue to be encouraged and should be used more flexibly. This is an area where providing field offices with regional workout-coordinator assistance would be particularly beneficial, since judging how much of the loan to restructure is always subjective and loan servicers will be looking for regional or headquarters guidance.

6. Redefine Federal Budgetary Evaluation of Workouts

All Federal budget projections work against a baseline that assumes the status quo continues. This is inappropriate in workouts, where doing nothing costs huge amounts of money. This reality is not reflected in budget scoring.

For example, more Flexible Subsidy funding sounds like an increase in the deficit, and it would be . . . if the properties involved, if left to their own devices, were certain not to default and cause assignments. As the recent Coopers & Lybrand and Price Waterhouse reports have shown, the cost of doing nothing could be as high as \$12 billion.

It's a truism among real estate workout professionals that money invested in prevention and workouts—whether in cash resources, better staff, authority to hire effective contractors, or otherwise—pays back manifold in losses prevented or reduced. Somehow *the budget scoring system must reflect the benefits of preventing or reducing defaults.* Otherwise the Federal Government will continue to spend little money on paper and enormous amounts in reality.

CONCLUSION

If HUD intends to control its deficits, it must reverse a series of policies based on neglect or disdain for affordable housing. The key principles are:

1. Install a new approach to troubled properties.
2. Assign enough resources—people and money—to do the job.
3. Change the criteria for evaluating workouts.
4. Become more aggressive with bad property managers.
5. Create funding mechanisms, targeted to workouts, that recognize that saving the property is a payback in itself.
6. Change the budget-scoring assumptions to reflect losses prevented as a credit against the cost of resources used.

Mr. Chairman, the affordable housing inventory is a national resource. Rather than disinvesting, which is what has happened for more than a decade, reinvesting in it makes sense for HUD.

ADDENDUM TO TROUBLED PROPERTY TESTIMONY PROTOCOL FOR STRUCTURING HUD WORKOUTS

The approach to developing workouts described in this addendum will lead to good workouts that preserve the real estate, protect the residents, and are cost-effective for the government. It has worked for me for more than 15 years.

Step 1: Assign a Capable Workout Coordinator

The coordinator (which can be a Department employee or a contractor), must have broad authority to negotiate the workout. The workout coordinator should have expertise (either through personal knowledge or through affiliated professional assistance) and be capable in the following areas:

- a. Real estate finance and financial analysis.
- b. HUD financing programs.
- c. Capital needs assessment.
- d. Ability to evaluate the general partner and property manager.
- e. Enough tax and accounting to evaluate the owner's motivations.

f. Enough partnership law to evaluate the owner's constraints.

g. Workouts and workout negotiations.

The workout coordinator must be intelligent, hard-working, energetic, optimistic, honest and forthright.

Workouts are very time-intensive to structure. A typical workout coordinator can probably handle no more than 4-5 workouts at once. Assigning a workout coordinator more properties than this simply results in all of them doing poorly.

Step 2: Determine What the Real Estate Needs

In evaluating what the property needs, the past is irrelevant; all liabilities, payables, or other historical obligations should be ignored (for the time being). Instead determine what the property needs in three areas:

Physical Improvements. Assume for the moment that the property was owned free and clear by an owner with sufficient capital to invest in anything that generated a positive payback. What physical improvements would be done? Identify and quantify all deferred maintenance. Identify all operational inefficiencies which have endured because no cash was available to correct them (examples include individual utility metering, better insulation, energy conservation measures, higher-grade or more durable replacements for systems being patched here and there). Identify all functional obsolescence (systems which work but are unresponsive to the marketplace). Develop a detailed cost to cure. Add in an initial deposit to reserves to cover the inevitable unforeseen needs.

Operational Changes. Is the property being well run? (In evaluating this, recognize that owners and managers who lack cash are often forced to make operational compromises that they do not like.) Is it being well managed? Are the people in place now capable of implementing the workout and its capital improvements program?

If the answer to any of these questions is No, changes must be made. See Step 3 below.

Financial Changes. If the property were renovated as above, and operated by capable managers, how much Net Operating Income (NOI) would it generate? Is this enough to carry the current debt service (before recasting of any arrearages)? If not, then either (a) more subsidy must be brought into the mix (usually through Section 8), or (b) the debt service obligations must be lowered (through partial assignment, reduction or restructuring of a HUD-held mortgage, or otherwise).

If the renovated property can carry its full current debt service load and then some, there will be marginal cash flow available to pay debt service on a capital improvements loan or arrearage note. If not, capital needs will have to be sourced in another manner (such as Flexible Subsidy).

Step 3: Evaluate the Ownership Entity's Capabilities

The workout will succeed only if the general partner and manager are highly competent. No workout can succeed if they are incompetent or unreliable.

When a property goes into default, lenders have a strong tendency to blame the owner and bash the owner, as if this will somehow solve the problem. This is understandable (not only the Department but private lenders frequently indulge in it) but it's usually wrong and is in any case wholly pointless and counterproductive. People who are under threat of retribution or litigation spend their energies defending themselves; this takes them away from working on the problem. Those same people are far less eager to try experiments that might fix the real estate, because failure will simply give ammunition to a lender which has already announced hostile intentions.

Of paramount importance is a dispassionate assessment of the owner and manager's performance. Have they been trying to address the problem? Does a review of the file document their efforts to identify the problem, find financial resources, and make changes? Have they been creative? Have they pursued alternatives aggressively?

Ultimately, the judgment about whether the current owner and manager are doing well is subjective; it can always be second-guessed. But it is crucial. Either the current owner and manager can be part of the solution, or they are part of the problem. If they are part of the problem, they must be removed, because no ship is seaworthy if its captain is Ahab.

Step 4: Evaluate Foreclosure From the Government's Perspective

Foreclosure, the Department's unilateral alternative, is no panacea. All the physical and operational problems just identified will persist even if the Department forecloses. In fact, they will usually worsen while the property is held in the HUD-owned inventory.

A simplified point-by-point analysis of foreclosure might include the following:

- Will the new owner and manager be better than the current one?
- Will the capital improvements program be the same as under a workout, bigger, or smaller? (Usually bigger.)
- Will the new subsidy needed be the same as under a workout, more, or less? (Usually the same or more—current HUD regulations require Section 8 for many more apartments than are usually receiving Section 8.)
- *Does the workout need the same resources that the Department must provide on a foreclosure, more, or less?* Often (but not always) the answer is Less.

Step 5: Decide Whether to Foreclose or Work Out

Foreclose if:

- A. It is financially superior, or
 - B. The current general partner and manager are unreliable and there is no way to displace them short of foreclosure.
- Otherwise, a workout will be superior. That being the case, the workout coordinator should develop the best achievable workout.

Step 6: If Workout is Superior, Negotiate Fair Contributions

Usually resources readily available in a workout are less than those needs. In this situation, the best principle is: *share the misery*. Parties will contribute more if they think that other participants are also doing more. (See the attached article, "Working Out Troubled Real Estate Properties: Making Stone Soup".)

Determining a fair contribution requires negotiation. Negotiation requires persuasion and judgment. Judgments are inherently imprecise. Given these circumstances, the objective should not be to extract the maximum dollar, the last drop of blood, but rather to obtain a contribution reasonably commensurate with the benefit to be obtained.*

Reasonableness can be exploited. This is why knowing the economics is crucial. Only by knowing what the other side gains and loses from workout and foreclosure will the workout coordinator be able to prove to the other side that a higher contribution is called for.

Step 7: Fund the Remaining Needs

Once the maximum feasible contributions have been negotiated for the other parties, the Department should fund what remains, for two reasons:

1. The lender is always the funder at the margin.
2. The workout has already been determined to be better than a foreclosure (see Step 6 above), so these fundings are in the Federal Government's best interest.

Often workout participants who reach this stage return to their original scope of work and reduce it—in effect, compressing Uses to reflect reduced Sources—on the grounds that "we can't afford it." *This is a fundamental mistake*. Under-sourced workouts fail. A failed workout is far worse than either a too-expensive successful workout or (usually) a foreclosure.

In making this recommendation, I recognize that Federal budget deficit considerations have made financial resources scarce within HUD. However, workouts and restructurings differ from most other calls on the Federal treasury in that doing nothing costs money. Some source must be found, because otherwise the Federal Government will pay more money later.

Many existing Federal and State resources are available which could be prioritized toward workouts. Among them:

1. Flexible Subsidy. (It was originally intended solely as a workout device.)
2. Low-Income Tax Credits. LITC's work reasonably well as a source of workout funds, in that the renovation work qualifies for the 9 percent credit.
3. Energy conservation loans and grants, some of which are Federal, others State or local in nature, are almost always applicable to workout situations.

A good way to assure that owners search diligently for outside funding sources would be to create a threshold matching requirement which could be waived only after the owner demonstrated that it had exhausted a variety of alternate funding mechanisms.

However, when all outside resources have been exhausted, if the workout is still superior to a foreclosure, the Federal Government should do the funding. An excellent litmus test is this: Determine the financial resources that the government

*I cannot remember negotiating a workout where I was completely satisfied with the contributions other parties were making; I always thought they were getting away for too little. But I was always satisfied that the contribution was in the reasonable range, and that the overall workout was desirable for my clients. The Federal Government should use a similar standard.

would be bound to provide to the property if HUD foreclosed. Then make all or some of those same resources available on a workout.

Obviously this requires changing existing regulations with respect to some programs; however the change is logical. If a property is worth spending a certain amount of resources to fix after it defaults, it should be worth those same resources to prevent the default.

If forced to choose to prioritize *within* the HUD inventory, it would make sense to target unassigned properties ahead of HUD-held loans, since preventing a claim against the FHA insurance fund is a significant money-saver which can easily be quantified and prove its payback worth.

Step 8: Recapitalize Arrearages in a Non-Foreclosable Way

As the last step, all arrearages (or soft second mortgages created via partial assignment or otherwise) must be recapitalized so that they:

- Are not foreclosable.
- Are paid only from future cash flow or sale/refinancing.
- Are shared at all levels of repayment. (That is, each dollar flowing out of the property, above its future obligations, should be shared X percent to repayment of old obligations, (100-X) percent to the owners.) Sharing creates incentives. Incentives create cash. Far better to have X percent of something than 100 percent of nothing.

These restructurings are necessary because no other party will participate unless the workout eliminates the threat of foreclosure. The objective is a workout in which, if everything that is projected occurs, the owners continue their ownership. Otherwise the owners will not cooperate; they will prefer immediate foreclosure to the aggravation and frustration of working hard, implementing a workout, and being foreclosed a year or two later.

IMPLEMENTATION OF LIHPRHA

Mr. Chairman, I appreciate this opportunity to present my views on the issues involved in HUD's multifamily inventory and, in particular, on HUD's implementation of the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA).

BACKGROUND AND CREDENTIALS

I am the founder and president of Recapitalization Advisors, Inc. of Boston (Recap). Our company specializes in helping owners of eligible properties realize their best possible result under LIHPRHA.

Recap currently represents approximately 65 owner groups owning 205 properties totalling 28,500 apartments in 29 states nationwide. About 50 of these properties are owned by partnerships affiliates with the National Corporation for Housing Partnerships (NHP), for whom we have also provided a comprehensive preliminary evaluation of another 170 LIHPRHA-eligible properties totalling about 20,000 apartments in their portfolio.

All told, therefore, our company is either working on or has analyzed about 400 properties totalling 50,000 apartments—roughly 15 percent of the LIHPRHA preservation inventory. This gives us a large base of experience from which to comment on LIHPRHA's implementation.

SUMMARY

1. *LIHPRHA will be less expensive than most people think.* Fewer properties will process than we originally thought, and those that do process will have lower values than the baseline estimates which Congress used when formulating the law.

2. *LIHPRHA's complexity cannot be reduced without sacrificing program objectives.* It is a direct result of its efforts to satisfy four different programmatic elements simultaneously.

3. *LIHPRHA is being implemented more slowly than contemplated by the statute.* This is due to two factors: (a) the learning curve in both the industry and the Department, and (b) the substantial time demands LIHPRHA makes on Department staff.

4. *Owners should be compensated for delays beyond those established by Congress.* This is important to preserve the fairness and Constitutionality of LIHPRHA.

5. LIHPRHA can be used to prevent defaults. LIHPRHA recapitalizations are a vehicle to prevent lower-value properties which might otherwise become expensive problems.

1. LIHPRHA Will Be Less Expensive Than Most People Think

From time to time I hear comments, either from the Department or on Capitol Hill, that LIHPRHA is a very expensive program. I believe this is totally false.

1. Every study has shown that preserving existing housing is many times less expensive than either building new housing or compensating displaced residents.

2. Activity under the program has so far been significantly less than expected. Owners are discovering their properties have lower value than they thought. Some properties with high value are encumbered by dysfunctional ownership situations (such as large accruing secondary notes owed to former partners) which hobble the owner from processing under LIHPRHA. Many other owners are daunted or discouraged by LIHPRHA's complexity and its processing cost.

3. Lost in the discussion of LIHPRHA's cost has been what I think is the single best indicator—expenditures. Congress has appropriated \$1.4 billion for LIHPRHA through FY 93. Less than half of it has been spent. Partly this is due to slow processing (see Point 3 below); partly it is due to low values.

4. Based on our specific analysis of about 400 properties totalling 50,000 apartments throughout the country, I estimate that average values will be as follows:

AVERAGE PRESERVATION EQUITY UNDER LIHPRHA

<u>Range of Preservation Equity per apartment</u>	<u>Percentage of preservation inventory</u>
Under \$5,000	33.9%
\$5-10,000	25%
\$10-15,000	20%
\$15-20,000	15%
\$20-25,000	5%
\$25-50,000	1%
Over 50,000	0.1%

Source: Recap Advisors estimates based on internal analysis

If we use the midpoint of the above ranges, the weighted average is \$9,500 per apartment of Preservation Equity.

LIHPRHA also contains provisions to ensure that necessary or money-saving rehabilitation work is performed when the property is recapitalized and preserved. While this may in one sense be considered an extra cost, it addresses problems endemic to the HUD affordable portfolio and will stabilize many properties that might otherwise be more expensive to repair later.

If LIHPRHA is going to be this cost-effective, why do people think it is expensive? To begin with, there are a handful of very high-value properties located throughout the country. When an individual property is identified, it's easy to assume that many other properties like it exist . . . but they are extremely rare. Manute Bol is not of average height.

Congressional and Departmental opinion has been skewed by the early experience; the first properties to complete recapitalizations (all under ELIHPA) are averaging materially higher values than this. However, it should be no surprise that those most harmed have processed quickest. As time goes by, owners are working their way down the value pyramid and discovering that many properties which are LIHPRHA-eligible are not LIHPRHA-viable—that is, they aren't worth enough to make going through the headache worthwhile. For many owners, this is an unpleasant surprise, and they tend to resist proceeding. Some properties which have decent values are waiting in hopes of improvement in their local real estate market.

Our experience with NHP is a good illustration of LIHPRHA's realities.* NHP has about 220 properties which are LIHPRHA-eligible. Of these, Recap Advisors esti-

*As a consequence of its social mandate, NHP's portfolio is perhaps a slightly lower value than the average. NHP was co-developer on many family developments in marginal settings with local co-general partners who lacked either sophistication or financial resources. Thus NHP's portfolio includes a larger than normal share of low-value urban properties. This notwithstanding, NHP is a much better proxy for the preservation inventory than the properties which

mate that about 85–90 are LIHPRHA-viable; the other 130–135 have either no Preservation Equity or so little that waiting is the indicated strategy. Within the 85–90 LIHPRHA-viable properties controlled by NHP, only about 50 are candidates for immediate processing; the others have some internal issue to resolve before they should proceed.

LIHPRHA's actual implementation cost, in terms of Section 8, will also be considerably lower than CBO estimates, because:

- Existing Section 8 LMSA now on the properties will be recaptured. The typical LIHPRHA property is probably 30–50 percent Section 8 LMSA today.

- HUD budget scoring overstates costs because it assumes little or no tenant share. In fact, tenant share contributions for the apartments which receive new Section 8 will be significantly higher than under the current Section 8 program. Under LIHPRHA, the universe of Section 8 subsidized apartments in eligible properties is expanded from the very low income residents (0–50 percent of area median) to include also low income (50–80 percent). At 30 percent of income, the tenant share of higher-income beneficiaries will naturally be higher; hence the government's cost will be less. These higher contributions will persist indefinitely, because LIHPRHA freezes the resident income mix at Plan of Action approval; like is replaced with like.

- The inventory is less valuable than it was five years ago: timing has favored the Federal Government. Most LIHPRHA-eligible properties were worth more in 1988–89, when their prepayment rights were confiscated, than they are worth in 1993–94, when owners will realize compensation. The areas most impacted by the real estate downturn—California and the Northeast—are also those which have so far driven LIHPRHA cost estimates.

LIHPRHA's costs will vary enormously according to sections of the country. The Northeast and West Coast will continue to be high-value and will have substantial activity. The Southeast is a low-value region with very little activity; the same is true of most of the Midwest and Southwest.

2. LIHPRHA's Complexity Cannot Be Reduced Without Sacrificing Program Objectives

Most of LIHPRHA's complexity is intrinsic to the program and flows directly from the statute. LIHPRHA resolves four competing interests:

- *Owners* are entitled to fair value.
- *Residents* are protected against displacement and guaranteed affordable rents.
- *Non-profit acquisitions* are heavily favored.
- *HUD's aggregate cost* is minimized.

Identify which of those program objectives is no longer important and I can give you a host of recommendations that would simplify LIHPRHA. However, if they are all equally important, then LIHPRHA must be complex.

3. LIHPRHA is Being Implemented More Slowly Than Contemplated by the Statute

Throughout the country, most LIHPRHA properties are moving more slowly through the process than contemplated by the statute and regulations. The Department has made an admirable attempt to provide guidance from Headquarters, but LIHPRHA is difficult to implement in HUD offices for two reasons:

A. *LIHPRHA has a long learning curve and touches a great many HUD branches.* LIHPRHA calls upon Loan Management, Architectural & Engineering (A&E), Valuation, Mortgage Credit, and the Regional Contracting Officer. Training has not penetrated into all corners of HUD area offices. Many people are doing difficult things for the first time.

B. *LIHPRHA differs from most other HUD programs.* In the typical HUD program, the mortgagor applies to HUD for incentives applying on a competitive basis. LIHPRHA is a mandatory program where owners have certain Congressional rights (namely to fair market value and LIHPRHA's incentives). Preservation Section 8 applies to a broader band of residents and has rent increases in a new manner. Section 241 processing combines the rehab and equity takeout loan components. The capital needs assessment differs from normal HUD property inspection. All these factors make learning slow.

I thus favor beefing up HUD's LIHPRHA staffing, and training existing staff more thoroughly. LIHPRHA calls upon HUD field staff to make many judgments, especially in the capital needs and appraisal phases. Staff must feel empowered to make these decisions; this can happen only if staff are properly trained, honestly motivated, and fairly judged on their performance.

have completed ELIHPA recapitalizations, the lion's share of which are located in California, Massachusetts, and other conspicuously high-value markets.

I estimate that for a HUD area office to process a typical LIHPRHA case requires on the order of 200–250 hours of staff time. That time must be made available somehow, else the program will suffer and owners will continue to be denied the timely compensation that is due them.

4. Owners Should Be Compensated for Processing Delays

To assure that LIHPRHA remains fair and Constitutional, owners should be compensated for processing delays beyond those contemplated by the statute.

Absolutely fundamental to LIHPRHA's Constitutionality is the principle of timely compensation. According to statutory deadlines, a LIHPRHA recapitalization will take no more than two years—precisely the period before the prepayment date when an owner is eligible to file. If LIHPRHA is delayed beyond statutory timeframes, owners lose the time value of their deferred Preservation Equity.

This has already occurred. The original LIHPRHA statute directed the Department to publish effective regulations by April 12, 1991; in reality, interim regulations became effective on May 8, 1992, more than a year late. Many owners were eligible to file before May 8, 1992; regulatory delay cost them money. They should be compensated for this delay.

Congress and the Department should rectify this taking by paying owners who recapitalize a lump sum equal to: Preservation Equity (established through LIHPRHA) \times 8.0 percent (the return on equity set in the LIHPRHA statute) \times Period of delay = Payment to compensate for delay.

This payment would be over and above the LIHPRHA incentives already established by statute. It is to LIHPRHA's Preservation Equity what interest is to an eminent domain takings payment.

Individual owners are also experiencing individual delays, some of them inordinately long. When these delays are the result of the Department's inability to meet LIHPRHA timeframes, rather than the owner's own inactivity, then the Department should also compensate these individual owners, using the formula outlined above.

The cumulative payments to all owners for all delays will be small in Federal budgetary terms, but large in meaning. Compensation deferred is compensation denied. Congress took away the owner's property rights in 1988; in 1993, many still have not been paid. Congress should acknowledge that the Fifth Amendment's guarantee of 'just compensation' means what it says, compensation based on *when* the private property was taken for public purpose.

This is important not simply because of fairness, but also practicality. If LIHPRHA were overturned on Constitutional grounds, the whole statute might be lost; owners might be able to prepay and residents might be evicted. Having taken the important and responsible step of developing a safety net which in theory can survive a Constitutional challenge, the Congress should not stint on the relatively small amount of money which would, in my opinion, eliminate the threat that the program might be found Unconstitutional because it lacks full and fair compensation for the property rights taken.

5. LIHPRHA Can Be Used to Prevent Defaults

LIHPRHA will influence only the top quartile of HUD properties; the universe of older multifamily properties is much broader:

Prepayment candidates (LIHPRHA viable)	25% of inventory
Viable housing which is aging (seldom noticed)	65% of inventory
Immediate default risks (attract headlines)	10% of inventory

In general, Congressional and Departmental effort focuses on properties at the extreme ends of the spectrum: the best and the worst. In between is a vast inventory of housing which is largely unnoticed but which has these useful characteristics in common:

1. The housing is decent, safe, and sanitary.
2. The housing is serving its residents.
3. The housing is inexpensive compared with other housing alternatives.
4. The housing is well run.
5. The housing is getting older and will need modest renovations.

The key point is the last one. Twenty years is a long time in the life of a property. Many long-lived systems need substantial overhauls: roofs, boilers, HVAC, electricity. In 1973 energy conservation was not even conceived; today it is paramount. To remain viable in the long run, property must be periodically renovated. But the existing budget-based approach to rents generally acts against this. Historically renovations have occurred on owner transfers, but these have dwindled to little or nothing with the elimination of tax incentives favoring real estate and the general flight of investors from real estate property.

LIHPRHA is the first viable renovation/owner transfer vehicle for affordable housing since the rescindings of 1983-84. Yet many properties which are LIHPRHA-eligible are not LIHPRHA-viable because they lack preservation equity sufficient to motivate owners to undertake processing. These are properties which the Federal Government would like to induce through LIHPRHA, because for very modest cost, the Department could renovate them and preserve them.

Ignoring the owner's takeout for a moment, what happens in a LIHPRHA recapitalization?

1. The property is preserved for its remaining useful life (at least 50 years).
2. The property is renovated (through the LIHPRHA rehab loan) to a standard that HUD believes will be adequate to preserve it for its remaining useful life.
3. Residents who do not receive Section 8 secure it.
4. The property's operations are re-underwritten, in light of 20 years' experience, and are thus made sounder.

Moving properties through a renovation-and-preservation program is an extremely cost-effective means of preventive maintenance and risk management. It's an ideal long-term asset management strategy for HUD.

Congress and HUD should want owners of marginal properties to go through LIHPRHA, because the derivative benefits to the government and the residents are so great. I believe this point is generally overlooked.

The less user-friendly LIHPRHA is, the fewer owners will participate, and those that will be dissuaded will be those where the Federal Government is gaining the greatest number of apartments preserved per dollar expended.

The Department has an opportunity to evaluate LIHPRHA's potential utility as a broader preservation device. In Title IV of the recent Housing and Community Development Act, HUD was directed to conduct a needs assessment of every property in its inventory, over a three-year period. Title IV should be actively implemented. From the survey results which it generates should come legislation designed to be pro-active in preserving and renovating existing housing. Although Title IV is not LIHPRHA-specific, properties studied under Title IV should be evaluated as LIHPRHA candidates, because LIHPRHA is a program that is in place today.

Specifically, a well-designed Title IV survey could target properties which have high current or projected future repair needs, or which would stabilize and improve themselves if provided with additional Section 8 subsidy. Once the Department knew which properties would most benefit (in a public-policy sense) from LIHPRHA recapitalization, it could then encourage these owners to process.

The Department has devoted substantial resources to training its field staff to handle LIHPRHA recapitalizations. To our knowledge, it has devoted few if any resources to educating owners as to the responsibilities and benefits of going through LIHPRHA. As a result, the owners who have come forward are principally those with high value. More education and outreach by the Department would probably encourage many owners whom the Department ought to want to have proceed under LIHPRHA.

I would personally welcome the opportunity to provide input to a discussion on how to protect the huge investment the Federal Government has made in its stock of affordable housing. Modest sums thoughtfully invested now will save billions five and ten years from now.

Mr. Chairman, thank you for the opportunity to testify. I would be pleased to answer any questions you may have.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM HENRY CISNEROS**

Q.1. Legislative versus Administration Actions—Section 203 of the National Housing Act currently allows for alternatives to Section 8 for property disposition, provided that the properties' long term affordability is maintained. HUD has evidently completed a few transactions in which it disposes of properties in conjunction with other types of subsidies that provide for continued low-income use. Has the Department fully explored its maximum flexibility currently permitted under the law? HUD currently has the ability to dispose of fully unsubsidized properties, as long as tenants are not eligible for Section 8 subsidies. Has HUD disposed of all such unsubsidized properties in its inventory? Why or why not?

A.1.a. HUD has explored its flexibility in using alternatives to Section 8 to maintain the long-term affordability of low-income housing. Section 203(d)(3) of the National Housing Act permits the Department to sell inventory without Section 8 subsidies as long as the properties remain available and affordable to low- and moderate-income persons for at least 15 years and such persons shall pay not more than 30 percent of their income for rent.

The Department can use this alternative in limited situations where it is feasible to reduce the selling price and/or provide other financial assistance to assure economic feasibility. Clearly, this alternative does not work when the debt service to amortize the cost of rehabilitation and/or operating expenses exceeds the low-income tenants' ability to support these costs at rents set at 30 percent of their income. It also does not work in areas of high costs and low incomes.

HUD has developed an experimental model using this alternative. It relies on establishing minimum rents to support operating expenses and the cost of rehabilitation at rents not exceeding 30 percent of the tenants' income. In effect, a floor rent is established. If prospective tenants would have to pay more than 30 percent of their income for rent, they would not be eligible to live in the project.

The first disposition program using this technique was approved in Washington, D.C. in July. Despite the attempt to use other forms of assistance, the development still needed 15-year project-based Section 8 assistance for 50 percent of the units and special financing terms. If this project is successful in operation, the Department expects to be using this approach more frequently as it gains experience with it, subject to the limitations noted above.

HUD also uses a second technique to sell properties with less than 100 percent Section 8 assistance. If a project has a small number of Section 8 income-eligible tenants, HUD can treat the units as zero income units, impose low-income use restrictions on these units and allow the marketplace to adjust the price it will pay for the properties. This technique is available only when the market rate units in a project can generate sufficient income to offset the income lost in setting the rents in the units to be preserved at zero. HUD has used this technique in unsubsidized projects with small numbers of Section 8 income eligible tenants.

A.1.b. No, HUD has not disposed of all the fully unsubsidized properties in its inventory and probably never will since there is an ongoing cycle of mortgage foreclosures and property acquisitions. On July 31, 1993, there were 190 projects in the HUD-owned inventory. About half of these projects are unsubsidized. Although a number of properties (e.g. Retirement Service Centers, Nursing Homes, etc.) can be sold without Section 8, it takes time to process properties for sale given the multitude of steps in developing a disposition program and the shortage of field office staff to process these plans. Some of these properties have a limited sales appeal because of large anticipated operating losses. Also, the emphasis on preserving low- and moderate-income projects has required the Department to concentrate its limited staff resources on preserving the subsidized inventory.

It should also be noted, for example, that while the inventory has increased from 62 projects in FY 1988 to 170 at the end of FY 1992 staff has not. This imbalance between workload and staff has negatively impacted our ability to move inventory.

Finally, the Department has tried to manage the unsubsidized inventory in a way that avoids dumping properties on local markets which would not only further depress real estate values in soft markets but would also adversely affect the Department's ability to reduce its losses through proceeds from sales.

Q.2. Prioritizing Property Disposition: Pension Fund Initiative—The Department, in its recently proposed FY 94 Budget Amendments, has announced the creation of a new housing program in partnership with pension funds. As originally drafted, HUD was to provide \$100 million in a partnership with private pension funds for 3,000 5-year project-based Section 8 subsidies. The Section 8 subsidies would leverage \$500 million in lending for low-income renters in assisted housing projects constructed or rehabilitated by the partnership. I understand that only about one third of those funds, or \$30 million, was to be used for "distressed multifamily properties," such as those in the HUD owned inventory.

Given the scope of HUD's property disposition problem, and the corresponding scarcity of resources to address this problem, wouldn't it make sense to increase this linkage, and orient the funding from the pilot entirely toward properties already owned by HUD?

A.2. The AFL-CIO initiative is meant to be a broader demonstration of the potential for pension fund financing to help revitalize communities than the multifamily property disposition inventory will allow. In addition to troubled multifamily property, the proposal will include homeless housing initiatives and revitalization activities in empowerment zones and enterprise communities. We think this broader effort is appropriate, but there are many details which would be worked out later, including priority for selection. This broader effort should allow us to derive significant benefit for assisting with the troubled portion of the multifamily inventory while still providing for a more valuable demonstration by including other initiatives as well.



Finally, the AFL-CIO initiative will have a job creation purpose as one of its goals. Though job opportunities may come about through the sale of a HUD-owned project, the Department's property disposition program is not a job creation effort.

Q.3. Potential Remedy: Adding New Insurance to PD Properties—The Department has mentioned the possibility of adding new insurance to HUD-held properties in order to facilitate their disposition. Isn't there currently a market for HUD-owned properties or HUD-held notes sold without insurance? How do the current affordability restrictions affect the demand for uninsured properties? Would there be a market for these properties, sold without insurance, if affordability restrictions were repealed? What percent of newly issued FHA insurance would likely default, after time?

A.3.a. Yes, there is a market for HUD-owned properties and HUD-held notes sold without insurance as long as the term of subsidy contracts equals or exceeds the length of the affordability restriction or the property is feasible with such restrictions. That market, however, is not as large as it would be if we were able to sell HUD-owned projects with commitments for insurance or if we could sell mortgages with insurance.

If we could sell projects and mortgages with insurance, potential bidders would have less difficulty finding a lender willing to lend money on a formerly troubled project or a purchaser for a mortgage, and could secure financing on more favorable terms. By facilitating more favorable financing, HUD could expect to receive higher bids for both projects and mortgages, other factors being equal. If mortgages could be sold with insurance, we could alleviate Congressional concerns about tenant protections, and preserve housing for low- and moderate-income families. While capital is available without insurance, it is scarce. Credit enhancements and debt sources have declined since the late 1980's for many reasons. This limits access to capital for distribution of the inventory.

Affordability restrictions do affect the demand for uninsured properties. However, the demand is more directly related to the availability of subsidy to maintain the property's affordability. Insurance only marginally improves the market for projects with affordability restrictions. Funding is more readily available when insurance is provided. In addition, insurance offers longer terms with lower interest rates. Such financing improves the price to HUD and reduces the level of rents HUD must subsidize.

Repealing the affordability restrictions (i.e., tenants pay 30 percent of income for rent) could possibly have a positive impact on the market for projects sold without insurance. Conventional financing has historically been available for properties without governmental restrictions. To some extent the addition of affordability restrictions makes lenders more cautious about lending, leading to reduced access to capital and tighter underwriting restrictions. Removal of affordability restrictions could possibly result in lower interest rates that could make a project more feasible.

However, the issue with lenders is whether there is an income stream to meet the project's operating expenses and debt service. Projects with affordability restrictions are, for the most part, formerly subsidized projects which house low-income families gen-

erally in low-income neighborhoods. Removing both subsidy and affordability restrictions could have a negative impact because neither existing tenants nor people living in the market area would be able to afford the rents needed to repair and operate the buildings.

A.3.b. PD sales using FHA insurance would likely utilize the Section 223(f) refinancing program or the Section 221(d)(3) nonprofit sponsor program. Such sales would be required to meet standard underwriting criteria of these insurance programs. The FHA actuary estimates that the ultimate claim rate for Section 223(f) projects would be approximately 18 percent and approximately 20 percent for Section 221(d)(3) projects. This is based on historic claim patterns of these two programs. These rates may not reflect either additional subsidies which might be provided in conjunction with sales or more-intensive underwriting to develop a workable long-range operational plan for the projects.

Provisions of the Credit Reform Act require that costs associated with defaults as well as holding costs and the costs of disposition net of premiums and recoveries be covered at the time of mortgage commitment through appropriated credit subsidies. Price Waterhouse has estimated the subsidy to cover these costs amounts to 2.9 percent for Section 223(f) mortgages and 12.41 percent for Section 221(d)(3) mortgages. These subsidies for PD sales would be scored against the GI/SRI appropriation for Credit Subsidies thus effectively paying the default costs at the time of the PD sale.

Q.4. State HFA's and Property Disposition—During the hearing, the Secretary focused on the role of State HFA's in single-family property disposition and in new production of multifamily housing. What role, if any, do you envision for State housing finance agencies in the management and disposition of HUD-owned and HUD-held multifamily properties?

A.4. We envision State housing finance agencies (HFA's) assisting HUD in developing innovative methods for disposing of HUD-owned projects in a manner that furthers the Department's mission to provide decent and affordable housing. Under a proposed demonstration program, HUD will enter into agreements where HFA's will undertake the responsibility for managing and disposing of a limited number of HUD-owned projects. We expect the demonstration to show innovative and cost effective solutions to the problem of the growing inventory of distressed multifamily housing. The results will also help the Department determine whether to utilize HFA's on a permanent basis in its property disposition program.

We are also considering use of State agencies and other public-sector partners, such as public housing agencies, to assist in management of both performing and non-performing properties in inventory. By contracting with such entities we will be able to access their expertise and lessen the servicing workloads of existing HUD staff.

Q.5. Costs of Current Law—**a.** How much will it cost the Department, over a 5-year period, to comply with current property disposition law? **b.** What is the current baseline? **c.** How are costs allocated among discretionary and mandatory funding streams?

A.5.a. It will cost the Department \$6.7 billion in Section 8 budget authority to comply with the current property disposition law and eliminate the backlog over the 5-year period between FY 1993 and FY 1998.

A.5.b. The baseline for FY 1994 is \$95,543,864.

A.5.c. All appropriated Section 8 funds are discretionary while all costs of holding in inventory are mandatory. In the absence of appropriated Section 8 subsidy to sell property, HUD incurs similar mandatory costs to the FHA fund.

Q.6. Credit Reform—How does the 1990 Credit Reform apply to HUD, especially in connection with HUD's ability to work out troubled notes? If HUD were to implement an aggressive workout and foreclosure program, how much would HUD need appropriated?

A.6. HUD manages its assigned mortgage inventory pursuant to authority provided in Section 7(i) of the HUD Act (P.L. 89-174) which grants the Secretary wide latitude to manage and dispose of assets acquired pursuant to the insurance claim process. This includes authority to modify assigned notes in a variety of ways and in particular to implement workout agreements.

One question which arises in connection with the Credit Reform Act (FCRA) is: Do workouts or other modifications of assigned mortgages constitute loan modifications under Credit Reform?

The Department's position is that Section 502(5)(D) of the FCRA provides a specific exemption from coverage by FCRA. Section 502(5)(D) states:

"(D) Any Government action that alters the estimated net present value of an outstanding direct loan or loan guarantee (*except modifications within the terms of existing contracts or through other existing authorities*) shall be counted as a change in the cost of that direct loan or loan guarantee." (emphasis added)

In this case modifications are provided for by both the existing mortgage contract, which permits the mortgagee to undertake forbearance actions, and through other existing authorities in the form of Section 7(i) of the HUD Act. Therefore, we do not believe credit subsidy is necessary to a loan workout program. Credit subsidy is not necessary to foreclose on loans either.

FCRA credit subsidy requirements would be required if the Department were to undertake a program of disposition of property or loans with insurance. The amount of the credit subsidy appropriation would be a percentage of the mortgage commitment amount which could be either 2.98 percent under the Section 223(f) refinancing program or 12.41 percent under the Section 221(d)(4) program. The 1994 Budget Justifications reflect \$8.3 billion of estimated assigned multifamily mortgages and \$609 million of acquired mortgages on hand at the end of FY 1993. The Administration has not proposed disposing of multifamily properties with insurance.

