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Assisted Housing: Section 8 Mark-to-Market Restructuring

Susan Vanhorenbeck, Domestic Social Policy Division

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Susan Vanhorenbeck
Analyst in Housing
Domestic Social Policy Division

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Assisted Housing: Section 8 Mark-to-Market Restructuring

Summary

When the Section 8 assisted housing program began in 1974, it provided project-based rental subsidies to encourage developers to build affordable housing for low-income residents. Under the program, tenants paid a fixed percentage of their income for rent, and the balance was paid by the federal government directly to the project owner. Many project rents were set higher than market rates, to encourage owners to participate. Moreover, throughout the 20 years of these original contracts, many of the rents were adjusted, to compensate for increased property costs. To reduce the cost to the federal government of renewing these contracts, a mortgage and rent restructuring program for certain Section 8 projects – commonly referred to as “mark-to-market” – was enacted in 1997. This program was scheduled to expire at the end of FY2001, but it was amended and reauthorized through FY2006 in Title VI of the *Labor, Health and Human Services, Education, and Related Agencies Appropriation Act for FY2002 (P.L. 107-116)* and signed into law by the President on January 10, 2002.

The original mark-to-market legislation established a program for restructuring FHA-insured mortgages for Section 8 project-based contracts, which expire on or after October 1998 and have above-market rents. By restructuring mortgages and lowering rents, the program reduces the federal costs of over-subsidized Section 8 properties. The 1997 law also created the Office of Multifamily Housing Assistance Restructuring (OMHAR) in HUD.

Even though the Act was signed into law in 1997, a director for OMHAR was not appointed until a year later, and operating procedures for implementing the program were not established until April 1999. For these and several other reasons, the Section 8 mark-to-market program did not begin assigning properties for restructuring until July 1999. In addition, owners of properties with mortgages that qualified for the debt restructuring were very skeptical of participating in the program as it was initially operated by HUD. Since then, OMHAR has streamlined the procedures and guidelines of the program, and has created an incentive package encouraging owners to participate. In the past year, momentum of the program has increased. As of June 6, 2002, according to OMHAR, 2,159 projects have entered the restructuring process, and 1,383 have reached completion.

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Assisted Housing: Section 8 Mark-to-Market Restructuring

Background

When the Section 8 assisted housing program began in 1974, it was a project-based rental subsidy program designed to encourage developers to build apartments which would provide affordable housing for low-income residents. Under this program, the tenants paid 25% (later raised to 30%) of their monthly income as rent, with the balance of the rent paid by the federal government directly to the owner of the development. The subsidy was attached to the unit, not given to the tenant, so that when one tenant moved out of the unit, another eligible tenant could move in and the subsidy would continue. Many of the projects' rents were set higher than market rents of comparable unassisted units in the area. Permitting these higher rents was the federal government's way of encouraging the building of affordable housing. Throughout the 20 years of the original contracts, many of these properties received adjustments to the set rents. When property costs increased, due to heating and cooling bills or the need for rehabilitation, the rent also increased, resulting in an increase of the Section 8 subsidy.

In 1997, Congress became concerned about the large number of insured multifamily properties in the Federal Housing Administration (FHA) portfolio that were also receiving Section 8 assistance. An examination of the portfolio found that approximately 10,000 of these properties were receiving Section 8 project-based rental assistance, and that a substantial number of these had rents higher than the rents of comparable, unassisted rental units in the same rental housing market. Congress believed that if changes to the Section 8 project-based program were not made, the renewals of expiring contracts for Section 8 assistance would consume an increasingly large portion of the discretionary budget of HUD in future years. The problem facing Congress was how to restructure the program in a way that would be beneficial to the families living in these projects, cost-saving for the federal government, and attractive to project owners.

In its investigation of the assisted multifamily properties, Congress also discovered that many of them were financially or physically distressed, including a number that were being mismanaged. Congress decided that the economic, physical, and management problems of these federally insured and assisted projects could best be solved by reforms that reduced the cost of federal assistance, while retaining the low-income affordability and availability of the housing stock. As a result of these findings, Congress designed a "mark-to-market" restructuring program which reduces the federal subsidies to owners of properties insured by FHA, lowers the above-market rents payable to these owners, and restructures the mortgages of properties so that owners can operate effectively on less income.

This restructuring plan was known as the *Multifamily Assisted Housing Reform and Affordability Act*. It was passed by Congress as Title V of the *VA-HUD Appropriations Act for FY1998 (P.L. 105-65)*. The Act was signed into law by the President on October 27, 1997, and it expired on September 30, 2001. The program had been reauthorized since that time through a series of continuing resolutions until January 10, 2002 when it was finally amended and reauthorized through FY2006, under Title VI of the *Labor, Health and Human Services, Education, and Related Agencies Appropriations Act for FY2002 (P.L. 107-116)*.

Multifamily Restructuring Reauthorization Bills

Legislation to reauthorize the mark-to-market program (H.R. 2589) was passed by the House on September 24, 2001. The version of this legislation that passed the House was revised from the version reported earlier by the House Financial Services Committee (H.Rept. 107-196). As passed by the House, the bill reflects a compromise between the House committee bill and similar legislation reported by the Senate Banking Committee (S. 1254, no written report). This compromise was included as Title VI of both the House and Senate versions of the FY2002 Labor, Health and Human Services, Education, and Related Agencies Appropriations bills (H.R. 3061, S. 1536). The House passed H.R. 3061 on October 11, 2001; the Senate passed its version on November 6, 2001. The final version of the bill was agreed to in conference on December 12, 2001, and was signed into law as *P.L. 107-116* by the President on January 10, 2002.

Description of the Restructuring Program

The Office of Multifamily Housing Assistance Restructuring (OMHAR)

Originally, an office was established within the Department of Housing and Urban Development (HUD) to oversee the restructuring of the mortgages of Section 8 expiring contracts. The director of the office was appointed by the President with the consent of the Senate, and in consultation with experts in housing finance and management. The director must be an expert in the financing and mortgage restructuring of multifamily housing. Other employees of OMHAR must be experts in real estate development, market analysis, management, finance, taxation, or auditing. These employees are hired by HUD, and may be contracted from other agencies as needed.

As amended by P.L. 107-116, the Director of OMHAR can now be appointed by the President without the consent of the Senate, and he is to report all of his activities and determinations to the Federal Housing Commissioner, who now has oversight of OMHAR.

OMHAR is not funded as a separate line item in the HUD budget. It is funded through various offices at HUD, but primarily through the Office of the Federal Housing Administration (FHA).

Participating Administrative Entities (PAEs)

The Multifamily Housing Reform Act authorized HUD to enter into portfolio restructuring agreements with housing finance agencies, public entities, and nonprofit or for-profit organizations. HUD was required to evaluate each of these agencies' qualifications to administer the restructuring of mortgages, and to notify the applicants as soon as possible of their acceptance or rejection to act as a PAE. PAEs must be involved in all critical functions of the restructuring process such as developing the rental assistance plan, screening owners and properties for mark-to-market, and monitoring the portfolio after restructuring. HUD is to utilize qualified housing finance agencies as much as possible for PAEs because they had shown expertise in providing affordable housing in the past.

The Act also encouraged interested public and nonprofit organizations to form partnerships with other entities, including public housing authorities (PHAs), private financial institutions, and housing organizations such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, if they wished to act as PAEs.

Screening Owners and Properties

The mortgage restructuring program is voluntary and owners with expiring Section 8 project-based contracts have the option of not renewing them. If owners have expressed an interest in participating in the program, PAEs are to screen owners to see if their properties are economically viable and in good physical condition. Owners of properties that are approved by the PAE then work with the PAE in developing a rental assistance plan for the development.

If properties have not been properly maintained, and the PAE believes that federal funds for the project have not been used efficiently, a contract with that owner is not renewed. HUD can provide owners with the opportunity to remedy the situation and improve their properties, or HUD may transfer the property to a qualified purchaser (usually a tenant organization or tenant-endorsed community-based nonprofit agency). The new owner is then eligible to participate in the restructuring program.

If a contract for a Section 8 property is not renewed, residents of the project will be informed early in the process, and they will be given enhanced vouchers so that they may remain in their units. Owners who choose not to renew their Section 8 contracts must notify HUD and the tenants (in writing) not less than 1 year prior to terminating the contract, and HUD will provide tenant-based assistance for tenants residing in that property. In addition, the owner must send a second notice to tenants of non-renewal of the Section 8 contract at least 120 days prior to contract termination. If this second notice is not sent, the owner may not evict the tenants nor raise their rents until a 120 day notice of intent to terminate the contract has been given and the time has lapsed.

A concern of many tenants has been having enough time to find affordable housing if an owner does not want to renew his contract. In answer to this concern, the reauthorizing legislation requires not only the owner, but OMHAR or a PAE

designated by OMHAR to notify tenants as soon as it is known that a contract will not be renewed, and also to inform the tenants of any assistance that will be available to them.

The Mortgage Restructuring Plan

Originally, the mortgage restructuring plan applied to Section 8 project-based properties with FHA-insured mortgages and rents exceeding market levels. As stated in the conference report on the 1997 Act, the program “is an effort to reduce rent levels to those of market rate properties, or at least to lower them to the minimum level necessary to support property operations and maintenance.”¹ Properties undergoing mortgage restructuring and resetting rents to market levels are called “full” participants in the program.

The debt restructuring is designed to reduce the outstanding mortgages of Section 8 property owners so that they can charge lower rents with reduced Section 8 assistance. This is done by restructuring the mortgage debt into two mortgages.

The first mortgage is intended to be for an amount that the PAE determines would be sustainable at lower rent levels. The second mortgage is for the difference between the first mortgage and the original amount of indebtedness immediately before the restructuring. However, if this amount is excessive, the second mortgage can be limited to the amount that the PAE determines the owner can be reasonably expected to repay. The interest rate for the second mortgage is determined by the PAE or HUD, but it can be no higher than the applicable federal rate. To make it easier on the owners of Section 8 properties, payment on the second mortgage is deferred until the first mortgage matures, unless there is evidence of excessive project income. If the second mortgage is held by HUD and the project is purchased by a tenant organization, a tenant-endorsed community-based organization, or public entity, HUD may modify terms of the mortgage, or forgive all or part of the indebtedness.

Owners who participate in the mortgage restructuring program must agree to maintain affordability and use restrictions, in accordance with regulations promulgated by HUD, which are intended to keep the property as affordable housing for low-income tenants for at least 30 years. The Section 8 contract is also renewed for 20 years.

As amended in *P.L. 107-116*, properties other than Section 8 project-based projects can now apply to participate in the mark-to-market restructuring program. Properties receiving assistance under the *Emergency Low Income Housing Preservation Act of 1987* or the *Low-Income Housing Preservation and Resident Homeownership Act of 1990* may participate in the restructuring program, if

¹U.S. Congress. House Committee on Appropriations. *Department of Veteran Affairs and Housing and Urban Development, and Independent Agencies Appropriations Bill, 1998*. Conference Report 105-297. 105th Congress, 1st session. Washington, U.S. Govt. Print. Off., 1997. p. 137.

participation would facilitate the sale or transfer of the properties to other owners who agree to participate in the Section 8 program.

Rent Restructurings

Some Section 8 properties are physically and financially sound so that owners do not have to restructure their mortgages in order to operate successfully at restructured market-level rents. Owners of these properties are referred to as “lite” participants in the program. Unlike properties undergoing a “full” restructuring of mortgages, properties undergoing only rent restructuring have no affordability or use restrictions on their properties.

In restructuring rent levels for expiring Section 8 contracts, PAEs are given great flexibility, but any determination of rent levels is to be made in consultation with project owners and tenants. In determining rent levels for restructured properties, PAEs are to compare assisted units to similar units of unsubsidized properties, and set rents at market levels. If no comparable units can be found in a market area, the restructured rents are to be set at 90% of the fair market rent levels.²

If a property with an expiring Section 8 contract has rent levels that are below comparable market rent levels, they are restructured at the market level, and the contract is renewed for at least 5 years. HUD has the discretion to conduct a comparison of rents once during the 5-year contract period to see if any adjustments to the rent are necessary.

If a property has rents equal to or greater than the market rents for the area, the rent restructuring for these properties will permit rents sufficient to cover budget-based cost increases. These budget-based rents are intended to provide owners of the property a reasonable rate of return after an adjustment is made for operating costs. The Act states that 20% of the projects being restructured may have budget-based rents of up to 120% of the fair market rent for the area.

Certain projects are exempt from these restructuring rent levels. They include projects insured by state and local governments, projects funded under Section 202, Section 515, or the McKinney Homeless Assistance Act, and properties with expiring contracts that house tenants who are particularly vulnerable (such as the elderly, disabled, or large families) and are located in areas where tenant-based assistance is difficult to use because of low vacancy rates, high return of unused vouchers, or lack of affordable housing. These projects, if restructured, are allowed to operate on budget-based rents at a higher level if necessary to keep the property as affordable housing.

HUD is required to renew all budget-based contracts for 5 years. At the end of the 5-year period, HUD will once again compare the property rent levels with comparable market rents to see if adjustments are needed.

²Fair market rents are rent levels established by HUD, based on the rents of comparable unsubsidized units in a Standard Metropolitan Statistical Area.

Some owners who would like to participate in the restructuring program may be told by the PAE that their properties need to be rehabilitated in order to meet physical standards before their mortgage can be restructured. Contracts for such projects are to be renewed at budget-based rents with an operating cost adjustment factor. There are provisions in the restructuring program to aid owners with rehabilitation costs. These provisions include the retention of residual receipts, project reserves, debt restructuring, and the rehabilitation grant program.

A concern of many owners when considering participating in the restructuring program has been the amount they have to contribute to the rehabilitation of their property under the program. The reauthorizing legislation maintains current law in requiring the owner to pay 25% of rehabilitation costs. This provision was included in the law as a safeguard against excessive rehabilitation costs and to prevent abuse. The new law also states that if a PAE determines that significant new features beyond the rehabilitation are needed (elevators, roof replacement, air-conditioning, etc.), the owner may be required to pay up to 25% of the cost, as determined by the PAE.

Implementation of the Restructuring Program

Although the restructuring program was authorized in 1997, OMHAR was very slow in getting organized, and the office did not begin to assign a large volume of properties for restructuring until 1999. The law authorized HUD to spend \$10 million a year for tenant-outreach on the mechanisms of the mark-to-market program. Because the program was slow in getting started, only about \$1.5 million was spent in the first year. OMHAR continued to approve grants, assuming that they would be paid for with unused funds carried over into the next fiscal year. Some legislators interpreted the original law as limiting funding for the restructuring program to \$10 million in any fiscal year with no carry-over of funds, and OMHAR was accused of violating the Anti-Deficiency Act which prohibits obligating government funds that have not been appropriated. As a result, OMHAR underwent OPM audits and an investigation by the Inspector General of HUD. These audits and investigations concluded that there was no wrong doing on the part of OMHAR.

Because of this conflict in allocating funds, the reauthorizing legislation clearly authorizes the Secretary of HUD to make available no more than \$10 million annually for the program, in addition to any amounts carried over from previous years.

There are other factors which have contributed to a slow start of the program. For example, some owners and PAEs have criticized the extensive requirements contained in OMHAR's operating procedures guide, as well as a level of review and oversight which many PAEs believed slowed the process down, but did not result in improvements to the restructuring plans.

Another major factor in delaying implementation of the program was the lack of interest or unwillingness of Section 8 property owners to participate in the restructuring program. Many owners felt that they had no incentive to commit their properties to the long-term use agreement that accompanies a "full" mortgage

restructuring. Also, many owners knew that rehabilitation would be necessary to bring their properties up to standard for renewals of contracts, and they were reluctant to contribute the required 25% of rehabilitation costs as prescribed in the law.

According to OMHAR, some PAEs were also responsible for the slow implementation of the program. OMHAR claims that some of the PAEs were slow in submitting restructuring plans and that many of these plans were unacceptable. OMHAR also noted that some PAEs did not have enough staff working only on the mark-to-market plans without a number of competing priorities.³

Finally, OMHAR reports that at the time they were processing contract negotiations with some PAEs, a significant number of properties entered into the mark-to-market program, causing processing delays and the need to temporarily extend some Section 8 contracts at above market rents.

OMHAR has taken action to address these factors attributed to the slow implementation of the restructuring program. It has streamlined its operating procedures and revised its guidelines for appraisals and physical inspections of property. In reviewing the restructuring plans, OMHAR staff have been instructed to ensure the reasonableness of the PAEs' underwriting and compliance with the regulations, rather than to spend time rewriting the restructuring plan.⁴

In an effort to encourage Section 8 owners to participate in the program, OMHAR has put together an incentives package including monthly capital recovery payments and performance fees for demonstrated sound management practices. Since these incentives have been offered, there has been an increase in the number of Section 8 owners requesting full mortgage restructuring.

Finally, OMHAR has sought to aid PAEs in the completion of restructuring transactions by dispatching experienced underwriters to assist them, and by providing specialized training for staff of PAEs at their request, or if OMHAR sees a need for such training.

As of June 6, 2002, 2,159 properties had entered OMHAR's mark-to-market program. Of these, about 52% are undergoing full mortgage restructuring and rent resetting levels; 48% are undergoing a "lite" restructuring only of their rents. According to OMHAR, there are approximately 3,800 Section 8 project-based contracts which have above market rents and are potentially eligible for the restructuring program.

P.L.107-116 reauthorizes OMHAR through September 30, 2004, and the restructuring program through September 30, 2006.

³U.S. General Accounting Office. *Multifamily Housing: Issues Related to Mark-To-Market Program Reauthorization*, GAO-01-800, July 2001. p.17.

⁴Ibid., p.19

Conclusion

Without reauthorization of the restructuring program, HUD would still be required to renew Section 8 contract rents and many of them would have to be renewed at rents exceeding market levels, or a number of FHA-insured properties could face foreclosures. The result would be higher federal subsidies under the Section 8 program. While the beginnings of the restructuring program were slow, once OMHAR overcame obstacles in setting up the office, selecting PAEs, and offering incentives to owners to participate in the program, the volume of owners requesting restructuring has increased.